CHAPTER ONE

THE NATIONAL INCOME

MEASUREMENT OF THE NATIONAL INCOME (THE NATIONAL INCOME ACCOUNTING)

The national income accounting is the process of measuring the value of the national income in a specific period of time, like a year. Before looking at the methods of measuring the national income, let us look into the circular flow of income, output and expenditure.

Circular Flow of Income

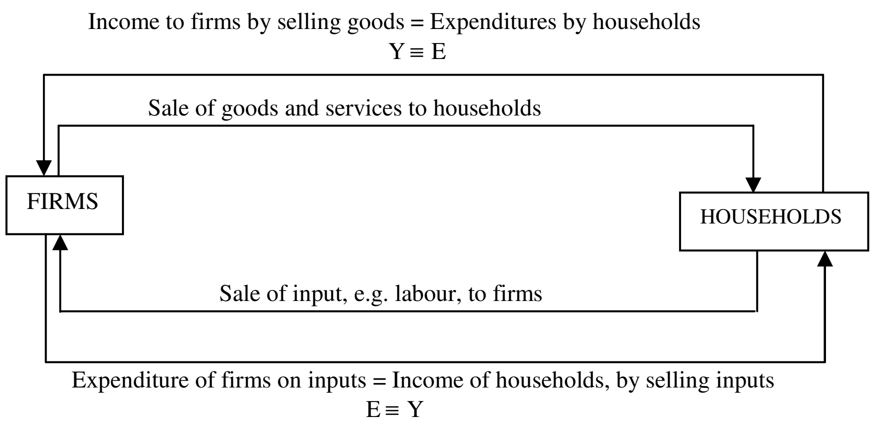


Figure 1.1: Circular flow of the national income

Assumptions of the Circular Flow

The circular flow of the national income has the following assumptions:

- It assumes a closed economy, in which there is no foreign trade such that commodities are produced and consumed within the country.
- There is no leakage, like savings. This means all the income received by individuals must be spent on goods and services and non remains for savings.
- Simple economy with two sectors of the economy which are, business firms and households (consumers)
- Households own the factors of production.
- It assumes that households supply all the factors needed for the production of commodities, and receive payments in the form of wages, rent, salaries, etc.
- It assumes that households spend all their income in buying goods and services that are provided by the producers. Therefore, the household's expenditure is the producer's income.

Note

From the circular flow of income, we can see that, each time any commodity is produced and sold. Its market value is equal to the value of the expenditure of the consumers on

that commodity and it is received as income, to all the participants (factors of production) in the process of production and exchange.

Leakages (withdraws)

This is an income that does not passed go through the circular flow of income. For example, tax, imports, savings and capital outflow. It has a contraction effect on the national income.

Injections

These are the additions to the domestic income, arising from other expenditures apart from the domestic households. It has an expansionary effect on the national income. Examples of the injections in the economy are: investments, the government expenditures, exports and capital inflow. If any of these injections change, it leads to a change in the national income.

Methods of Calculating the National Income

There are three methods of calculating the national income, namely:

(i) Product method
(ii) Expenditure method
(iii) Income method

(i) Product Method:

In this method of computing the national income, the value of the national income is obtained by taking the values of goods and services produced by the citizens of a given country for period of time. The national income, by this method can be reflected by the Gross National Product.

The Gross National Product

This is the total value of all the goods and services produced in the country in a particular year. It is usually calculated at factor cost that is, excluding subsidies and taxes imposed on the goods or services. It is, in fact, the cost of the total output of the producers. After taking account of the net income from abroad, which is the value of exports less the value of imports, we have the Gross.

National Product at Factor Cost

Having calculated the Gross National product, it is possible to calculate the national income. All that is required is to make an estimate of the capital consumption that has taken place during the year, and deduct this from the Gross National Product. Thus, it will be seen that, the national income is in effect the net national product, that is, the total volume of production after allowance has been made for that part of production that was devoted to making goods the depreciation of the existing capital equipment.

Gross National Product at Factor Cost of country X in 1978.

Table 1.1: The national income by product method

Products or services	**Year 1978** **Tshs. million**
Agriculture, forestry and fishing	3715
Mining and quarrying	4467
Manufacturing	40690
Building and construction	8610
Gas, electricity and water	4772
Transport and communication	11688
Distributive trades	14687
Insurance, banking and finance	11268
Public administration and defence	10197
Ownership of dwellings	8578
Public health and education	9674
Other services (net)	11137
Gross domestic product Net income from abroad	139483 3352
Gross National Product at factor cost	142835

The national income (1)

	YEAR 1978
	Tshs. million
Gross national product Less capital consumption	142835 18310
The national income	124525

This method can be divided into two approaches:
- Final product approach
- Value added approach

- *Final Product Approach:* In this approach, the national income is calculated by taking the market values of all the final products produced in the country, for a given period of time. For example, assume a simple economy that produces only one commodity, e.g. cloth and the market value of the cloth produced is Tshs. 1000/=. By applying the final product approach, the value of the national income, for this simple economy, will be equal to the value of the final goods produced, i.e. Tshs. 1000/=
- *Value Added = Value of Next Stage – Value of the Previous Stage,* so the value of the final product = the sum of values added in different stages; from the first stage (production) up to the last stage (exchange). For example, in a simple economy, a cotton farmer produces cotton and sells it to a threading company at Tshs. 400 per kg; the threading Company produces threads and sells it to the Weaving Company at Tshs. 700 per kg. The Weaving Company processes the product and sells it to the Textile Company for Tshs. 900 per kg. The textile Company produces cloth and sells it to a final consumer for Tshs. 1000 per kg.

  If the value of cotton is calculated by adding 400 + 700 + 900 + 1000, it will be equal to Tshs. 3000. This will result into double counting, triple counting, and quadruple counting. Therefore, in order to obtain the correct value of the Gross

National Product, only the value added is taken into account. From the above example, the value of a national product of a simple economy will be therefore calculated as follows:

Table 1.2: Value added method

Section (stages)	Value added (Tshs.)
Farming (400 - 0)	400
Threading (700 - 400)	300
Weaving (900 - 700)	200
Textile (1000 - 900)	100
GNP of the economy	1000

(ii) Income Method:

In this method, the value of the national income is obtained by summing incomes such as rent, wages, profit, interest, dividends, allowances for the depreciation of fixed assets, returns on royalties, surpluses, etc.

Example 1

In this example, the value of the national income is obtained by taking the total income derived from economic activities as shown in table 1.2 above, whether the national income is calculated as the total volume of production or the total income derived from economic activities the two totals must be the same. Indeed, the volume of production and the national income are the same thing. It is certain that this must be so, since what is paid by a consumer for a commodity is income to all those who have had a share in its production. Each commodity, it is said, represents merely a collection of the services of those who have obtained the raw materials changed its form in some way, transported and marketed it at wholesale and retail stages.

Table 1.3: Total income - Income methods

Type of income	Year 1978 Tshs. million
	96156
Income from employment	12091
Income from self-employment	2037
Pay in cash and kind of the Forces	9842
Rent	13968
Profits of companies	5187
Profits of public enterprises	3352
Net income from abroad	202
Other income	
Total income	142835
Less capital consumption	18310
The national income (the net national product)	124525

Example 2

Find the national income by income method, given the following information:

- Payment to workers in a current year amounted to Tshs. 60 million.
- Existing surpluses Tshs. 30 million.

- Rent and royalties accrued Tshs. 50 million.
- Share holders' dividend Tshs. 10 million.
- Profit realized Tshs. 5 million.

Solution

The national income = wages + profits + surpluses + rent (royalties) + dividends
The national income = 60 m + 30 m + 50 m + 10 m + 5 m = Tshs. 155 million

(iii) Expenditure Method

A third method of calculating the national income is to find the total of all expenditures incurred during the year.

Table 1.4: Total Expenditure - The national incomes (3)

Type of expenditure	**Year 1978** Tshs. million
Personal consumption	17592
Food	7366
Clothing	13855
Housing (Rent and rates; maintenance)	4650
Fuel and light	7471
Alcoholic drinks	3933
Tobacco	11258
Household goods	1388
Books, newspapers, etc	5227
Cars and motor-cycles; running costs	3207
Travel	1387
Insurance	4233
Catering (meals and accommodations)	1952
Entertainments	11019
Other goods and services	94538
Total personal consumption	
Expenditure of public authorities	30964
Gross domestic capital formation	28731
Net income from abroad	3352
Less indirect taxes on goods and services	157585 -14750
Gross national expenditure at factor cost	142835
Less capital consumption	18310
Net national expenditure	124525

Therefore, the national income by expenditure method can be summarized that the national income =C + I + G + (X - M)

Where;

C = Individual expenditures on the consumption of final goods and services
I = Firms expenditures on investment goods and the government expenditures on capital goods.
G = The government expenditures on items such as social services, wages to civil servants, security, etc.
X = Foreigners' expenditures on the consumption of goods and services produced by the

country citizens. Exports must be included, because they earn income to the citizens of a country.

M = Expenditure by firms, individuals and the government on goods and services produced by foreigners. Expenditures on imports must be excluded, because they involve on outflow of income from the economy.

Determinants of the Size of the National Income

The national income is determined by the following factors:

- *The available stock of natural resources:* The availability of a large stock of natural resources such as minerals, water sources, soils, weather condition, etc. influences the growth of the national income, such that a low stock of natural resources leads to low production, consequently to a low the national income and vice versa.
- *The stock of capital goods:* The size of the national income in the country depends on the size of the capital goods available in the country. If the size of capital goods, such as factories, machines, infrastructure and raw materials, is large, the country would experience a fast growth of the national income, unlike when a nation is facing shortage of the capital goods.
- *Level of technology:* The size of the national income depends on the level of technology that a country has achieved, if production is done by using advanced technology in the country, the output as well as the national income would be large.
- *The availability of Human Resources:* The national income is influenced by the available labour, both skilled and unskilled, as well as the managerial capacity, efficiency and the number of entrepreneurs.
- *Political Situation:* When there is political stability in the country, investors become confident to invest their capital, therefore, resulting into an increase in the national income.
- *The government Policies and Actions:* The growth of the national income depends on sound economic policies, which are formulated by the government in order to stimulate economic growth.
- *Terms of Trade:* This is the ratio of the price index of exports and the price index of imports, if the price index of a country's export is greater than the price index of import, the national income will grow, since more income will be received through exports, unlike when the terms of trade are unfavourable.

Concepts Relating to The national income

The concepts relating to the national income are as follows:

- *GNP = Gross National Product:* This is the sum of the market values of the goods and services produced by the citizens of a given country for a period of time. GNP is obtained by summing the value of goods and services produced by citizens of a country, living within and outside the country.
  Or
  Gross National Product (GNP): This is the national income produced by citizens of a country, living within and outside the country.
  GNP = GDP + factor income from abroad.

- *GDP = Gross Domestic Product:* This is the sum of the market values of goods and services produced within the country by all the residents (people living in the country) in a given period of time.

Or

Gross Domestic Product (GDP):This is the national income produced within the country by all the residents, both citizens and non citizens.

- *Net Factor Income from Abroad (N.F.I):* This is the difference between income received by citizens of a country, working abroad, and income received by foreigners who are working in the country or who have investment in the country.
  N.F.I = Net income from abroad – Income received by foreigners.
  N.F.I = income inflow – income outflow.
  GNP = GDP + net factor income from abroad.
  GNP = GDP + (x – m).
  GDP = GNP – net factor income
- *Net National Product (NNP):* Is the sum of the market values of goods and services produced by the country's citizens after the deduction of capital consumption, i.e. depreciation.
  NNP = GNP – depreciation.
  Depreciation is the wear and tear of the capital goods that are used in the process of production. NNP is the national income.

Note
Depreciation is the payment on capital for their wear and tear. So, it is the cost incurred on capital goods and therefore, it can be regarded as a factor income on the capital goods. This means that it can be added to other incomes, when computing the national income by income method.

Income Method
The national income (N.I) is the summation of incomes including depreciation.
N.I = Rent + Interest + Profit + Wages + Depreciation.

GNP at Market Price and at Factor Cost
Gross national product can either be measured at market price or at factor cost. When it is measured at market price, it includes indirect taxes imposed by the government, but excludes subsidies provided by the government to the producers and consumers. When it is measured at factor cost, it includes only factor costs, i.e. factor incomes. This means that, in order to get gross national product at factor cost, indirect tax must be deducted and then add subsidies:

GNP at market price = GNP at factor cost + indirect tax – subsidies
GNP at factor cost = GNP at market price – indirect tax + subsidies
GDP at market price = GNP at factor cost + indirect tax – subsidies
GDP at factor cost = GDP at market price – indirect tax + subsidies
National disposable income = National income – direct tax
Personal disposable income = Personal income – income tax

Uses of The national income Statistics
The national income statistics has the following uses:

- The national income statistics can be used to show the growth rate of the national economy by comparing the GNP of different years. For example, if the GNP of country X, in the year 2000, was Tshs. 20 million and GNP, of the year 2001, was Tshs. 40 million, then the growth rate of the national income was 100 percent. The national income statistics can be used to compare the standards of living of different

nations by computing the per capita income of each country. Per capita income is income per person. It is the average income of each citizen in a certain period of time in a given country.

$$\text{Per capita income} = \frac{\text{GNP}}{\text{Total population.}}$$

- The national income statistics can be used to show the performance of each sector of the economy, to the national income, by examining the contribution of each sector to the national income i.e. by using the national income data. We can know the contribution of agriculture, industrial, mining sectors, etc. In this case, the government can be in a position to determine which sector should be given priorities in assistance.
- The national income statistics shows the distribution of the national income to various factors of production, which is from the national income data. We can know how much each factor of production is rewarded/paid.
- The national income statistics can be used by the government to make decisions concerning the allocation of resources for different and alternatives uses. It means that, by knowing the national income, the government is able to make good decisions on how to allocate its resources in different sectors of the economy. Also, the national income statistics enable the government to estimate the revenue and expenditures in a given financial year.
- Economic problems can easily be identified through the national income statistics. Examples of such problems are inflation, fall in income, unemployment, etc.
- The national income can also be used to reflect the welfare of the citizens of a country. An increase in the national income implies improvement in the welfare, especially when there is a fair distribution of the national income.
- Estimates of the national income are very important in the formulation of a national budget by the government, i.e. the government uses the national income statistics to estimate its revenue and expenditures for the current year. Likewise, the government may use the national income data to formulate national plans and policies.

Difficulties in Computing/Compiling the National Income

The following are the difficulties in calculating the national income:

- *Problem of data*: In many countries, especially in LDC's, it is very difficult to obtain accurate data because researchers do not provide the correct information, lack of trained man power, lack of modern equipment; and also due to the fact that, in LDC'S, many activities are done in informal sectors, in which it is very difficult to obtain official data. Therefore, in LDC's, the information concerning the national income is mostly estimated.
- *Subsistence economy*: In LDC'S, the main economic activity is agriculture, but it is performed at subsistence level. It means, peasants produce for their own consumption. Therefore, their output is never included in computing for the national income, because the national income statistics takes into account only goods and services which are produced and exchanged formerly. Because of the existence of subsistence economy in LDC'S, the national income of these countries is largely under estimated.
- *Illegal trade (black market):* Some output that is produced in the country may be sold in illegal markets within or outside the country. Therefore, it is very difficult to obtain data about such output when computing the national income.

- *Inflation*: The rise in the general price level or inflation has the effect of increasing the nominal value of the national income. When there is inflation in the country, prices of goods and services are higher, so when computing the national income at market prices (current prices), the value of the national income will be higher because it may be exaggerated by the amount of inflation. The national income will therefore be so high in nominal terms, but in real terms, the national income will be low. In order to see whether the real the national income has increased or not, the nominal the national income must be adjusted at the value of the inflation rate.

$$\text{Real NI} = \frac{\text{Nominal GNP}}{\text{GNP deflator}}$$

- *Housewives activities*: The contribution of housewives and domestic activities are excluded from the national income figures. Also, services of household employees are excluded in many developing countries. Many women are housewives and therefore, their domestic services are not included in the national income accounting.
- *Self-employment*: Sometimes people do various activities such as building houses and repairing of machines by using their own labour. Therefore, it is very difficult to value such activities and include them in the national income statistics.
- *Problem of estimating the value of depreciation*: In order to get net national product we must remove depreciation from GNP, now the problem is that it is very difficult to distinguish new investments or machines from old investment or machines because machines may be replaced from time to time.
- *Difficulties in estimating income received from abroad*: Information concerning the citizens who work abroad is very difficult to obtain, and therefore, it is very difficult to compute accurate data concerning the income of citizens who work abroad.
- *Problem of double counting, triple and quadruple counting*: This problem occurs when the value of raw materials or intermediate products is counted. This results into double counting because the value of raw materials or intermediate products is included in the value of a final product. For example, the value of cotton is included in the value of cloth. If the value of cotton is counted when computing the national income, it will result into double counting because the value of cotton is included the value of cloth. Also transfer earnings such as students' allowances are included in the government expenditures, but if they are counted as incomes, it may result to double counting.
- *Problem of goods in progress*: There is difficulty in estimating the value of goods which are still undergoing production in factories or machines.
- *Insufficient manpower for compiling the national income*: In LDC's, there is lack of enough manpower to compile the national income.

The Weaknesses of Using Income per Capita Statistics to Compare Standard of Living among Countries

In principle, income per capita can be used to measure and compare the standards of living among countries. But in practice income per capita is a weak indicator of the standard of living, and therefore cannot be a good measure for the differences in the living standards among countries. This is due to the following reasons:

- *There are differences in the types of spending among countries*: Some countries spend a larger part of their total expenditure on welfare services, such as health and education, while other countries spend a larger part of their income on expenditures which do not improve the living standards of the people like buying arms.

- *Income per capita does not take into account differences in the distribution of the national income*: In some countries, especially socialist countries, the GNP's are very low but there is fair distribution of GNP among the citizens. So the standards of living of the people is much higher while in capitalist countries, GNP are much higher but there is uneven distribution of the national income, which makes the standards of living of most of the people to be low.
- *The national income figures do not take into account the problem of insecurity*: Some countries are rich in terms of GNP but there is lack of peace and security. So the standard of living of the people is very low while other countries have lower GNP'S but they are more peaceful, which make the standards of living of the people to be relatively higher despite the low per capita income.
- *The national income figures do not take into account the differences in climate among the countries*: Differences in climate among the countries make big differences in welfare among the countries. For example, many resources in cold countries are devoted to provide warm houses, warm clothing, heated swimming pools, etc. All these activities are counted as production activities, and thus are included in GNP, while in hot countries, warmth freely available, nobody adds an extra amount to GNP, to produce warmth.
- *The national income figures do not take into account the differences in the nature of consumptions*: Even in the countries with the same GNP, the standards of living may not be the same, because people consume different commodities due to environmental and social differences. For example, a larger number of Indians neither eat meat nor drink alcohol for religious reasons. The French put higher priority on good food, wine and luxury than housing as opposed to Americans who put a higher priority on good houses than food and luxury.
- *There are differences in the price structures in countries*: Prices of goods and services in different countries are different, which makes the comparison difficult. For example, in poor countries, due to habit food stuffs, such as meat, fruits and vegetable forms a large part of people's expenditures, and they are sold at very low prices, while in developed countries, food stuffs are very expensive. This means that, the total expenditure on food stuffs in LDC'S is smaller as compared to the developed countries. Therefore, if we use income per capita to compare the standards of living, then standards of living of LDC'S will be lower than that of developed countries.
- *Problem of data of the national income and population*: In less developed countries, there are problems of getting accurate data concerning the national income and population. The data on them are estimated, while in developed countries, there are little problems of getting data concerning the national income and population. Therefore, it is quite unreasonable to compare the national income and the per capita income of developed countries and LDC's.
- *Comparisons of the national income (per capita income) are made by using official foreign exchange rates*: When comparing the GNP of two countries, the official exchange rates are used. However, these exchange rates do not provide the reality in terms of the actual purchasing power of the two currencies, in the two countries under comparison, since one currency may be weaker than the other but citizens in that country may enjoy much higher standards of living, due to the low price of goods which are sold in that country. For example, if we intend to compare income per capita between Tanzania and Kenya, we will use the exchange rates of the currencies of Tanzania and Kenya. However, this may be misleading, because of the differences in the price structure of

the commodities between the two countries. For example, in case the exchange rate between the two countries is 1 Ksh: 10 Tshs, it may not be possible to buy, in Kenya, with one Kenyan shilling the same amount of goods and services, which can be bought in Tanzania by 10 Tshs. If these goods are more expensive in Kenya than Tanzanians will be able to buy more quantity of goods with Tshs.10, than Kenyans, with Kshs1.

- *Inflation*: When there is inflation in the country, the nominal the national income become higher than in the country where there is no inflation. Therefore, when comparing the income per capita, the country with inflation will have a higher income per capita than the country without or with low inflation.
- *Other forms of wealth*: The national income statistics consider the flow of wealth created by production around the economy, but a substantial proportion of wealth such as houses is not in terms of money and, therefore the national income statistics do not take into account the well being gained from them.
- *Social costs and benefits are not counted*: The national income is based on private costs and benefits, while social costs, such as pollution, are not calculated. Thus, a country may have a high the national income figure, but its citizens are poor in terms of welfare, due to the social costs, such as pollution.

Determinants of the national income: Keynesian Approach

According to Keynes, the determinants of the national income are the aggregate demand and supply. The national income is determined by the level of equilibrium between the aggregate demand and supply. In order to elaborate this theory, Keynes made some assumptions as follows:

- He assumed an economy with two sectors, which are, households and firms. The households supply services to the firms and they receive money. Firms sell their products to the households.
- There is no the government expenditure.
- The price of products should remain constant.
- The supply of labour and capital should be constant.

Aggregate Demand

These are the total expenditures in the society. They comprise of firms' expenditures on buying investment goods (I) and the consumption of goods and services by individuals(C).
C = Consumption of goods and services by individuals
I = Firms' expenditures on buying investment goods.
Aggregate Demand (AD) = Consumption + Investment
According to Keynes: The national income (Y) = C + I = Aggregate demand

Aggregate Supply

This is the total amount of goods and services which have been produced in the country in a given period of time. When these goods and services are sold, they provide income to the people and are counted as the national income. Part of this income is used for consumption, and the remaining part may be saved. Therefore, the aggregate supply or the national income is expressed as follows:

$Y = C + S$

Where;

Y = aggregate supply
C = consumption

S = saving
The equilibrium level of the national income will be as follows:
Y = C + I = Aggregate Demand
Y = C + S = Aggregate Supply
C + I = C + S
I = S = Equilibrium level of income

Equilibrium Level of Income

This is the level of income which is attained when the aggregate demand is equal to the aggregate supply, that is, when the planned expenditures are equal to the output level, the equilibrium level of the national income will be as follows:
Y = C + I = Aggregate Demand
Y = C + S = Aggregate Supply
C + I = C + S
I = S = Equilibrium level

The national income = Amount spent on consumers goods + Amount saved
That is, Income = Consumptions + Savings
Therefore, Savings = Income - Consumptions

Then taking the national income in real sense is the total volume of production which comprises consumers' goods and producers' goods (real capital or investment):
The national income = the amount of consumers goods produced + the amount of capital goods.
That is, Income = Consumptions + Investments
Therefore, Investments = Income – Consumption

Therefore, savings and investments are each equal to income, less consumptions. They must, therefore, be equals to one another, and so,
Saving = Investment.

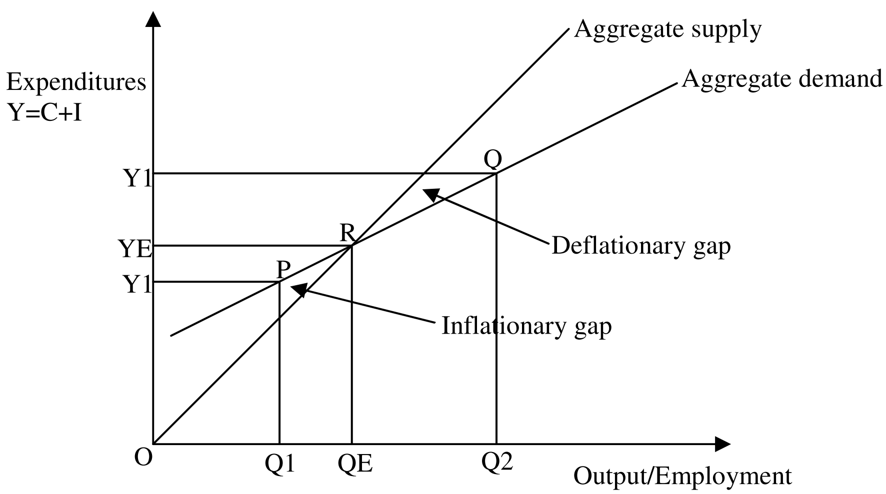


Figure 1.2: An equilibrium level of income

In figure 1.2 above:

- The equilibrium level of income/full employment level is at point R where the planned expenditures (aggregate demand) is equal to the output level (aggregate supply).
- At point P, we find that the spending level (Aggregate demand) C + I +G + X - M is greater than the amount of output produced, i.e. inflationary gap. In this case, no equilibrium can be achieved under these conditions, because when spending is greater than output, business must raise up-production to meet the surplus demand, because businesses want to supply whatever is demanded. Thus, at point P, forces are set in motion to push output to higher levels, that is, towards point R.
- At point Q, the total output (Aggregate supply) is greater than the total expenditures (Aggregate demand), i.e. deflationary gap. Therefore, the economy cannot remain at this point for a very long time. This situation forces producers to cut back on output, thereby reducing the GDP, and returning the economy to the equilibrium level of income at point R.
- Point R is the only point at which there is stable equilibrium.

The relationship between Consumption and Incomes

The relationship between consumption and income can be shown by the *consumption function*. This is the mathematical relationship between consumption and income. It is given by the equation:

$C = a + by$

Where;

C = consumption

a = autonomous consumption (consumption which does not depend on income changes). Even if there are changes in income, this consumption will be constant.

b = Is the proportionate part of the total income consumed. It expresses the rate at which consumption changes when income also changes.

Y = This is income (disposable income).

It can be expressed graphically as shown below:

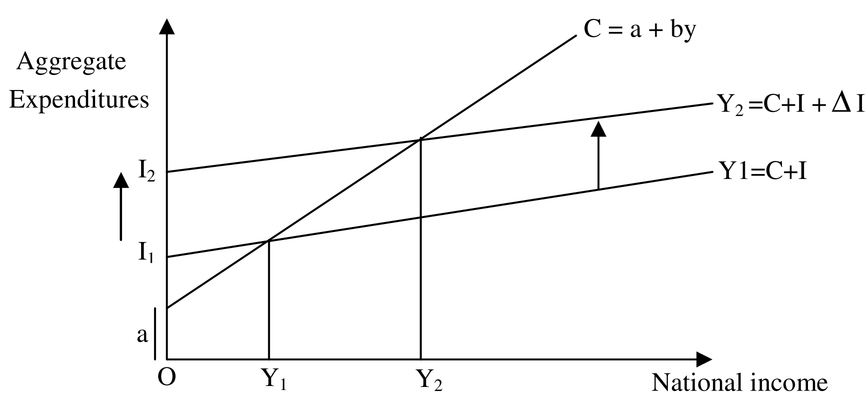


Figure 1.3: Relationship between consumption and income

In figure 1.3 above, an increase in the aggregate expenditure i.e. C + I, lead to an increase in the national income.

Propensity to consume

This is the proportionate part of the total or extra income used for consumption. There are two types of propensity to consume:

- Average propensity to consume (APC)
- Marginal propensity to consume (MPC)

Average Propensity to Consume (APC)

This is the consumption per unit of income. OR is the ratio of consumption to income. It can be expressed as

$$APC = \frac{c}{y} = \frac{a + by}{y}$$

Marginal Propensity to Consume (MPC)

This is the additional consumption due to a unit increase of income. MPC is the slope of the consumption function, from the consumption function C = a + by

$$MPC = \frac{\Delta c}{\Delta y}$$

Derivation of MPC:

$$C = a + by$$
$$C + \Delta C = a + by + \Delta y$$
$$C + \Delta C = a + b\,(y + \Delta y)$$
$$C + \Delta C = a + by + b\Delta y$$
$$\Delta C = - C + a + by + b\Delta y$$
$$\Delta C = - (a + by) + a + by + b\Delta y$$
$$\Delta C = b\Delta y$$
$$b = \frac{\Delta C}{\Delta Y}$$
$$MPC = b = \frac{\Delta C}{\Delta Y}$$

The relationship between Savings and Income

The relationship between the savings and income can be shown by the *saving function*. This is the mathematical relationship between income and savings. It can be derived as follows:
From the aggregate supply:

$$Y = C + S$$

Substitute a + by into C

$$Y = a + by + S$$
$$-S = a + by – Y$$
$$-S = a + y\,(1 – b)$$
$$S = -a + y – by$$

$S = -a + y\,(1 – b)$ Saving function.

Propensity to Save
This is the proportionate part of the total income used for saving. There are two types of propensities to save:
(i) Average propensity to save
(ii) Marginal propensity to save

(i) Average Propensity to Save
This is the ratio between saving and income. That is, it is the amount of saving per unit income.

$$APS = \frac{S}{Y}$$

Where;
S = Savings
Y = Income
S = -a + y (1-b)
Therefore,

$$APS = \frac{-a + y(1-b)}{y}$$

(ii) Marginal Propensity to Save
This is the additional savings per unit increase of income.

$$PMS = \frac{\Delta S}{\Delta Y}$$

Derivation of MPS:
Y = C + S
Y = the national income
C = consumption
S = Savings
A change in income (-Y), will cause a change in both consumption and savings, as indicated below:

$$\Delta Y = \Delta C + \Delta S$$

$$\frac{\Delta Y}{\Delta Y} = \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y}$$

$$I = \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y}$$

But $\frac{\Delta C}{\Delta Y} = MPC = b$

Therefore;

$$1 = b + \frac{\Delta S}{\Delta Y}$$

$$1 - b = \frac{\Delta S}{\Delta Y} = MPS$$

MPS = 1 - MPC
MPC = 1 - MPS
MPC + MPS = 1

Table 1.5: Savings, the national income, consumption, average propensity to consume, marginal propensity to consume and marginal propensity to save

Saving (Tshs.)	Income (Tshs.)	Consumption (Tshs.)	APC	MPC	MPS
-1000	5000	6000	1.2	-	-
-500	10000	10500	1.05	0.9	0.1
0	15000	15000	1	0.9	0.1
500	20000	19500	0.975	0.9	0.1
1000	25000	24000	0.96	0.9	0.1
1500	30000	28500	0.95	0.9	0.1

Concept of the Multiplier

Multiplier is the rate at which the national income changes due to changes in any of the determinants of the national income, such as investment. There are various types of multiplier, namely, investment multiplier, the government expenditure multiplier, import and export multiplier, etc.

Simple Investment Multiplier

This is the rate at which the national income change due to the change in investments

It is given as $\dfrac{\Delta Y}{\Delta I}$

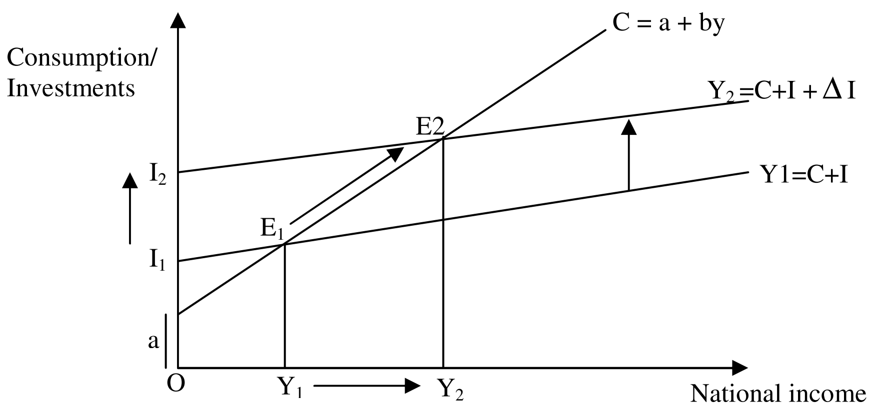


Figure: 1.4: A simple investment multiplier

In figure 2.4 above, the changes in aggregate demand can either be caused by changes in consumption function or changes in investments function. When investments expenditures change from I_1 to I_2, it will cause a change in aggregate demand from Y = C + I to Y = C + I + ΔI. Due to this change, the equilibrium point will change from E_1 to E_2. A simple investment multiplier can, therefore, be derived as follows:

ΔY = Y2 – Y1
ΔI = I2 – I1
Y = C + I

Where C = a + by
Therefore, Y_1 = a + by + I
Collect like terms
Y - by = a + I

Factorize

Y (1 - b) = a + I

Divide both sides by 1 - b

$Y_1 = \frac{a + I}{1 - b}$

Equation (1)

Y2 = C + I + ΔI

Where;

C = a + by_2

Therefore,

$Y_2 = a + by_2 + I + \Delta I$

Collect like terms

$Y_2 - bY_2 = a + I + \Delta I$

Factorise Y terms

Y2 (1 - b) = a + I + ΔI

$Y_2 = \frac{a + I + \Delta I}{1 - b}$

Equation (2)

But ΔY = Y2 – Y1

$\Delta Y = \frac{a + I + \Delta I}{1 - b} - \frac{a + i}{1 - b}$

$\Delta Y = \frac{a + I + \Delta I - a + I}{1 - b}$

$\Delta y = \frac{\Delta I}{1 - b}$

Divide both sides by ΔI

$\frac{\Delta Y}{\Delta I} = \frac{\Delta I}{1 - b} \div \Delta I$

$\frac{\Delta Y}{\Delta I} = \frac{I}{1 - b}$ = multiplier, multiplier is denoted by "*k*" and *b* is the Marginal propensity to consume (MPC), therefore;

Multiplier (k) = $\frac{1}{1 - MPC}$ Or $\frac{1}{MPS}$

Example 1

Given that the marginal propensity to consume is 0.2, find investment multiplier.

Solution, multiplier = $\frac{1}{1 - MPC} = \frac{1}{1 - 0.2} = \frac{1}{0.8} = 1.25$

Example 2

Given that the marginal propensity to save is 0.5, find the multiplier.

Solution, Multiplier = $\frac{1}{MPS} = \frac{1}{0.5} = 2$

Example 3

Effect of the change in investments on income: Given that the national income of country X is $10 million in year Y, the marginal propensity to consume is 0.6 and the level of

consumption is \$4 million. Calculate the effect on income due to a planned investment of \$5 million

Solution

Investment multiplier is given by:

$$K = \frac{\Delta Y}{\Delta I} = \frac{1}{1-b} = \frac{1}{1-MPC}$$

$$k = \frac{\Delta Y}{\Delta I} = \frac{1}{1-MPC}$$

$$k = \frac{1}{1-MPC}\text{, since MPC = 0.6}$$

$$k = \frac{1}{1-0.6}$$

$$k = \frac{1}{0.4} = 2.5$$

$$\text{Since } k = \frac{\Delta Y}{\Delta I}$$

$$2.5 = \frac{\Delta Y}{5}$$

2.5(5) = \$12.5 million

Therefore, when investments are increased by \$5 million, the level of income will be changed by \$2.5 million to get a new income of \$12.5 million.

How a Multiplier Operates

When investments are made, they cause changes in income. Suppose X invests Tshs.100 million in the construction of a house, the money will be used to buy the building materials and to pay building contractors. The receivers of that income it means the suppliers of building materials and the workers will also use part of the income for consumption and the remaining will be savings. Assuming that MPC is 60 percent or $\frac{3}{5}$ of the total income, their total spending will be Tshs. 60 million. Therefore, 60 million will be received as income to those who will sell goods and services to the construction workers and the suppliers of building materials.

Assuming that the MPC of those who supply goods and services is again $\frac{3}{5}$ or 60%, then their total spending will be 36 million. This process will continue but come to a halt when additions to savings total to 100 million. This is because the change in savings is now equal to the original change in investment and, therefore, the economy is returned to equilibrium, because the savings, S, once again is equal to Investment, I, i.e. S = I. At this point, the additions to income total Tshs. 250 million, thus Tshs. 100 million extra investments has created a Tshs. 250 rise in income. Therefore, in this case, the value of the multiplier is 2.5. Table 1.6 below, gives a summary of the operation of the multiplier.

Table 1.6: Operation of the multiplier

Rounds of spending	Increase in income (Tshs. million)	Cumulative increase in income in millions
1	100.00	100
2	60.00	160
3	36.00	196
4	21.60	217
5	12.90	230
6	7.80	238
7	4.68	243
8	2.80	245.04
9	1.08	247.12
10	1.008	249

Cumulative increase in income can be calculated by using

Formula, $= \frac{G_1}{1-r}$

Where G_1 = initial amount of investment

r = MPC

In the example above, where the initial investment is Tshs. 100 million, the total increase in income is equal to $\frac{100}{1-0.6} = \frac{100}{0.4}$ = Tshs. 250 million.

The relationship between Multiplier (K) with MPC and MPS

(i) *The relationship between Multiplier and MPC*

- When MPC increases multiplier also increases.
- When MPC decreases multiplier also decreases.

Therefore, MPC and multiplier are directly proportional. For example, to find the multiplier given the following:

- MPC = 0.2

Solution

$$K = \frac{1}{1-\text{MPC}} = \frac{1}{1-02} = \frac{1}{0.8} = 1.25$$

- When MPC = 0.5

Solution

$$K = \frac{1}{1-MPS} = \frac{1}{1-0.5} = \frac{1}{0.5} \times \frac{10}{10} = \frac{10}{5} = 2$$

(ii) *The relationship between Multiplier and MPS*

- When MPS increase multiplier decreases.
- When MPS decreases multiplier increase.

Therefore, MPS and multiplier are inversely proportional.

For example, if MPS = 0.2, find multiplier.

Solution

$$K = \frac{1}{MPS} = \frac{1}{0.2} = 5$$

Multiplier = 5

(ii) When MPS = 0.5

Solution

$$K = \frac{1}{MPS} = \frac{1}{0.5} = \frac{10}{5} = 2$$

Multiplier = 2

Assumptions of the Multiplier

Multiplier has the following assumptions:

- Multiplier assumes that all the extra income is used for consumption. If it is used to pay previous debts, it may cause a leakage in the multiplier process.
- Multiplier assumes that, there is no scarcity of goods and services. If there is scarcity, the extra income cannot be used to purchase goods and services.
- Multiplier also assumes that the economy is operating below full employment. If the economy would have been at full employment, there would be no resources available to produce extra goods and services so as to meet the extra demand for goods and services.

Limitation of Multiplier in LDCs

In less developed countries (LDCs), multiplier is less effective because of the following reasons:

- *Lack of well established capital industries*: As a result, any investment established must involve the purchase of capital goods, such as machines from developed countries. The importation of capital goods from abroad causes a leakage (withdraw) to the multiplier. Multiplier assumes that there is no leakage, because leakage causes outflow of income abroad.
- *Lack of entrepreneur abilities*: In LDCs, there is lack of entrepreneurship abilities. Therefore, any investment must involve the importation of experts from abroad. This also causes a leakage to the multiplier because it involves outflow of income abroad.
- *Poor productivity due to low level of technology*: The output produced in LDCs is very low. As a result, LDCs are forced to import goods and services from abroad, which also cause a leakage to the multiplier because it involves income outflow.
- *Poor infrastructure*: In LDCs, there is poor means of transport and communication. Therefore, it is cheaper sometimes to import goods and services from abroad than to buy then within the country where transport and communication are very poor. The importation of goods and services, in turn, result into the leakage of the multiplier process.
- *In LDCs, workers are paid very low wages*: Therefore, in order to meet their daily transactions of buying goods and services, they have to borrow money. Therefore, when they get income, they use the income to settle previous debts instead of buying other goods and services. So this causes a leakage to the multiplier.

Investment

Investment is the additional stock to the existing stock of capital.

Gross Investment
This is the total purchase of productive assets per unit time, say a year. It can be zero or positive. Investment is said to be zero when there is no purchase of new productive assets. It is said to be positive when the worn out assets are being replaced.

Net Investment
This is the difference between the gross investment and depreciation.
Net investment = Gross investment – Depreciation.

Determinants of Investments
Investment can be determined by the following factors:

- *Cost of investment:* Large cost of investment deters investments while low cost of investment encourages more investments.
- *Availability of infrastructure:* Infrastructure, such as roads, electricity and railways, provides conducive environment for the growth of investments, while the absence or poor infrastructure limits the growth of investments.
- *Market rate of interest:* Large interest rates discourage investors from borrowing money for investment, while lower rates of interest encourage borrowing for investment.
- *Expected returns from investment:* If investors expect to generate large profits from certain investments, they will invest more on such investments.
- *Legal protections:* If the government provides legal protections to investors, the investors will be encouraged to increase investments, unlike when there are no legal protections
- *Expectations:* When investors expect a boom to occur, they will increase investments but reduce investments, when they expect a recession to occur.
- *Level of consumption (purchasing power of the people):* Large consumption capacity of the population encourages more investments than low consumption capacity.
- *Size of the market:* The larger the size of the market, the larger the rate of investments, while the smaller the size of the market, the smaller the rate of investments.
- *The government policy and actions:* The growth of investments depends upon good the government's economic policies which facilitate investments, and the way the government creates a conducive environment for the growth of investments.

Acceleration Principle
According to Keynes, the factors which influence investments are marginal efficiency of capital that is the profitability of investment and the rate of interest. According to the accelerator principle, there is another factor, which can affect investment; the output level. When output or income increases, it stimulates more investments. The principle states that, "there is a direct proportional relationship between the stock of capital and the output level". This means that, when output level changes the stock of capital also changes by the same proportion. Therefore, the following occurs:

- When output increases, it leads to an increase in the stock of capital
- When output decreases, it leads to a decrease in stock of capital.

Note

- Increase in stock of capital is investment.
- Decrease in stock of capital is decrease in investment.

Therefore, investment is caused by the increase in output level. The accelerator theory stems from the simple and mechanical assumption that "firms wish to keep a relatively fixed between the output they are currently producing and their existing stock of fixed capital assets". This ratio is called capital-output ratio. For example, a capital output ratio of 4:1, or simply 4, means that, at constant prices, Tshs. 4 of capital is required to produce Tshs.1 of output.

Assumptions of the Principle

Acceleration principle assumes the followings:
(i) Firms produce at the least cost with a combination of inputs.
(ii) There are no credit constraints; funds for credits are readily available.
(iii) All the output produced are demanded, i.e. there is no excess output.

In the accelerator theory, the level of the current net investment, in fixed capital depends on the changes in income or output in the previous year.

- The larger the change in output or income in the previous year, the larger the change in investment in the current year.
- The smaller the change in output or income in the previous year, the smaller the change in net investment in the current year.

$I = v(\Delta Y)$
$\Delta Y = Yt - Yt - 1$
Or
$It = v(Yt - Yt - 1)$
Where;
It = Net investment in the current year
Y_t = The national income in the current year.
Y_{t-1} = The national income of the previous year.
V= Is the capital output ratio, or the accelerator coefficient, or simply the accelerator.

Gross investment equals net investment plus any replacement investment to make good capital that was worn out in the course of production in the previous year.
Gross investments in the current year =V(Yt – Yt - 1) + replacement of investments

Table 1.7: Net investment - Example given that capital output ratio is 4.

Year t	**V(current income-previous year income)Tshs. in millions**	**Net investment**
2002	4(100 m – 90 m)	40 m
2003	4(110 m – 100 m)	40 m
2004	4(130 m –110 m)	80 m
2005	4(140 m - 130 m)	40 m

In table 1.7 above, the national income grows in both years, between 2001(which is year t-1 in row 1) and 2002, we have assumed that income grows by Tshs.10 million, via the capital output 4. This growth of income of Tshs. 10 million induces net investment of Tshs. 40 million. This level of investment is required to increase the capital stock so that the desired capital output ratio can be maintained at the current higher level of income.

In the second row, income continues to grow in 2003 by the same absolute amount, ths10million, thereby inducing a constant level of investment (compared to 2002) of Tshs. 40 million. But in 2004, in row 3, the growth of income speeds up or accelerates-from an

absolute rise of Tshs. 10 million to Tshs. 20 million. The level of investment doubles. The size of capital stock required to maintain the capital output ratio is Tshs. 80 million larger in 2004 than in 2003. Finally, we have assumed, in row 4 that, the growth of income falls back again to Tshs. 10 million in 2005. Although income is still growing, net investment now declines back to its previous level of Tshs. 40 million.

This example shows how the accelerator theory derived its name. It is the rate of growth of income and output rather than the fact that output is growing, that determines whether investment is growing, falling, or at a constant level. Accordingly, therefore:

- If income grows by a constant amount each year, net investment is also constant.
- If the rate of growth of income speeds up or accelerates, net investment increases; and if the rate of growth of income slows down or decelerates, net investment declines. Thus, relatively slight changes in the rate of growth of income or output can cause quite large absolute rises and fall in investment as firms adjust their capital stocks to the required level.

Weaknesses of the accelerator theory

- Investment is induced more by profits rather than the level of output, when profits increase; it provides incentives to business people to invest more.
- It assumes that resources are always available, so that increase in consumption would automatically lead to an increase investments.

Relationship between the Multiplier and the Acceleration Principle

Multiplier and accelerator principle work together to influence employment and income, a change in investments cause a change in income and employment through the multiplier process, a change in income induce more investments through the accelerator principle.

How Multiplier and Accelerator Can Lead to Unemployment?

Multiplier and accelerator can lead to unemployment in the following ways:

- Multiplier depends on the size of the marginal propensity to consume (MPC). When marginal propensity to consume is large; it will cause a large increase in investments which will lead to an increase in income through a multiplier process. An increase in income will induce more investments and create more employment through the accelerator process. If the marginal propensity to consume is small, the size of the multiplier will also be small as well as induced investments. This will cause a fall in the national income and, consequently, les investments hence, unemployment.
- Multiplier effect may lead to an increase in output, hence more employment in a certain industry but to less output and to unemployment in another industry. For example, an increase in the government expenditures in the construction industry will lead to more income in the sector through the multiplier process and induce more investments through the accelerator process. This will increase employment opportunities in the sector and attract more labour, which will join the construction industry. Such the mobility of labour will cause shortages of labour in other industries and thus, a fall in output. This discourages investments and therefore, leads to unemployment.
- Multiplier can also cause unemployment when the economy has reached its full employment level, where aggregate supply (total output) is equal to aggregate demand (total expenditures). At this level, the levels of profits and the marginal propensity to

consume are high. This may cause over investments and so inflation, in which the demand for labour will be greater than the supply of labour, hence unemployment.

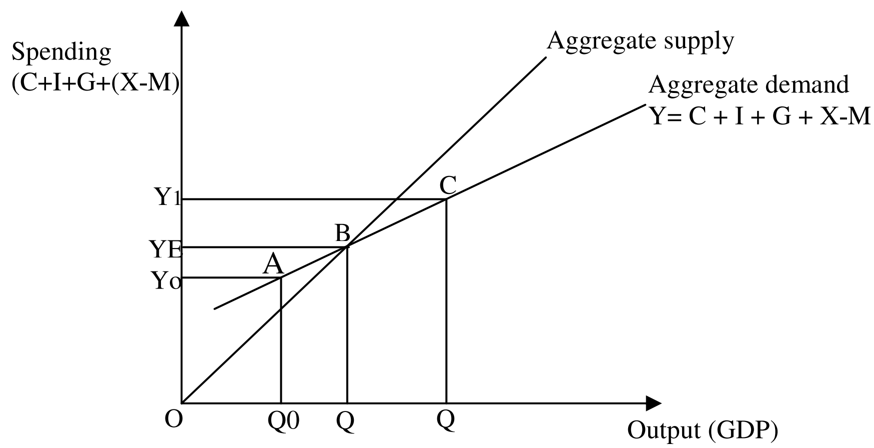


Figure 1.5: Relationship between multiplier and accelerator

In figure 1.5 above,

- The aggregate supply and aggregate demand are at equilibrium level at point B, the value of output (GDP) is equal to the value of the total spending by firms (I), individuals (C), The government (G), Export (X) and imports (M).
- Point B is also the full employment level. At this level, all workers who need employment, at the current wage rates have it, money income, output and employment will no longer increase in proportion; the supply of labour will eventually become completely inelastic, and so will be the output. Therefore, any increase in aggregate demand met with completely inelastic supply of output, will result in higher prices (inflation), which will make workers to demand for higher wages, and therefore, to entrepreneurs to demand less workers. A decrease in the demand for labour will lead to unemployment.

The Concept of Induced Investments and Autonomous Investment

Through the multiplier process, a primary increase in spending, such as additional consumption or investment produce some further rounds of secondary spending. Through this secondary spending, further tertiary spending with its effects may occur on investments.

Businessmen will need additional capital goods (investments) to expand their productive capacity to match with the increased demand for capital goods. Such increase in the demand for capital goods due to increase in demand for final goods are referred to as *Induced investment*. This is, therefore, caused by endogenous factors i.e. factors which are within the national income determination model such as consumption, the government spending and investment. If any of these factors change, they influence increase in the national income through the multiplier effect, and induce more investment through the accelerator principle.

Autonomous investment, on the other hand, is caused by exogenous variables, i.e. variables which are not within the national income model, such as changes in technology. Autonomous investment has no relationship with the accelerator. For example, if there is

a new invention in television production, firms would go ahead and invest in such development, but this new investments have no link with the previous changes in the income of these firms.

Relationship between the Rate of Interest and Investment

Interest rate is the cost of borrowing. If the rate of interest is high, borrowing is discouraged, and if the rate of interest is low borrowing is encouraged. However, this relationship is determined by the *Marginal efficiency of capital,* which does show the relationship between the desired stocks of capital to the rate of return (yield), that additional unit of capital will produce. Return is related to the rate of interest. Suppose, for example, that a capital project were to yield 10%, while the rate of interest were 12%, investors would not be interested in it. However, if interest were to fall to 8%, investors might wish to invest. The capital stock they desire would have increased.

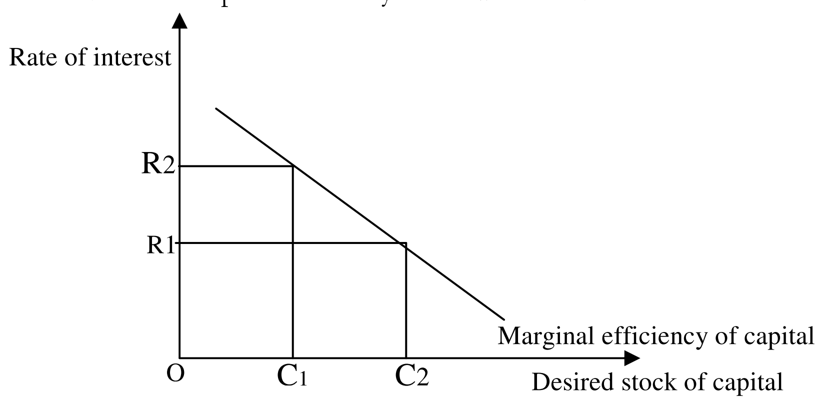


Figure 1.6: Relationships between the Rate of Interest and Investment

In figure 1.6 above, the higher the rate of interest R2, the lower the desire for capital goods at C1. At a lower rate of interest, R1, the desire for capital goods is higher at C2; implying that investors are more willing to invest at a lower rate of interest than at a higher rate.

Present Value (PV)

The present value of future payments or a series of payments represents the amount received today that is equivalent in value to the future payment or payments.

Example 1

For instance, if the discount rate is 10% per annum, the present value of this year of Tshs. 1100 if earned next year is Tshs. 1000. This is equivalent to Tshs.1100 next year because Tshs.1000 invested at going market interest rate of 10% yields Tshs. 1100 next year. If there are financial flows over a number of years, the discounted sums are additive and can be found by the formula:

Present value;

$$= \frac{X}{(1-r)} + \frac{X2}{(1-r)2} + \frac{X3}{(1-r)2} + \frac{Xn}{(1-r)n}$$

Where:

X = Future value

R = Interest rate

In the example above;
The present value in year 1:

$$= \frac{X1}{(1+r)} = \frac{1100}{1+10\%} = \frac{1100}{1+0.1} = \frac{1100}{1.1} = 1000$$

The present value in year 2

$$= \frac{X1}{(1+r)} + \frac{X2}{(1+r)}2 = \frac{1100}{1+10\%} + \frac{1100}{(1+0.1)}2 = \frac{1100}{1.1} + \frac{1100}{(1.1)}2 = \frac{1100}{1.1} + \frac{1100}{2.2} = 1000 + 500$$

= 1500 this value is to be added to the present value of year 1 to get the present value of year 2, it will therefore be equal to 1000 + 500 = 1500

Example 2

Suppose a machine with a known life of only two years is expected to yield $ 242 each year. The machines' present cost is $400, and the rate of interest is 10%. Is the investment profitable?

$$\text{Present value} = \frac{242}{1+0.1} + \frac{242}{(1+01)^2} = \frac{242}{1.1} + \frac{242}{1.21} = 420$$

Present value = 420, present cost = 400. Since the present value is greater than the present cost, investment is profitable.

Income inequalities

Income inequalities refers to the differences in incomes or wealth among the people, which makes some to be classified high income earners and others, classified as low income earners.

Forms of Income Inequalities

Income inequalities can be in the following forms:

(a) *Regional Inequalities:* These are the type of income inequalities existing among or between regions of a particular country. The causes may be the differences of natural endowment in resources, uneven distribution of infrastructures and centralization of investments. For example, in Tanzania, some regions such as Dar es Salaam, Arusha and Mwanza are far ahead in terms of income compared to other regions, such as Lindi, Mtwara and Kigoma, due to the above reasons.

(b) *Sectoral Inequalities:* These are the differences in income which exist between or among sectors of the economy. For example, in Tanzania, people who work in the mining and other industrial sectors have higher income than those who work in the agricultural sector.

(c) *Intra-Sectoral Inequalities:* These are the income inequalities which exist within one sector of the economy or society. For example, within the agricultural sector, there is income inequalities between modern agricultural sector and a traditional or subsistence agricultural sector.

(d) *Rural-Urban Inequalities:* These are the inequalities which exist between the rural and urban areas. Urban areas have higher income and wealth than the rural areas due to the presence of various kinds of investments such as industries, good infrastructure and trade.

(e) *Individuals Inequalities:* These are the income inequalities which exist among individuals in the society. Such inequalities exists due to reasons such as private ownership of the major means of production, luck and opportunities, differences in talents and differences in levels of education.

Causes of Income inequalities

Income inequalities is brought about by the following factors:

(i) *Inheritance:* Some people are born in rich families and others are born in poor families. Those who are born in rich families may inherit wealth from their parents and become rich, while those who are born in poor families have nothing to inherit from their parents, hence they remain poor.

(ii) *Differences in natural abilities:* Different people have different mental and physical abilities. These differences cause differences in wealth among the people. For example, talented footballers, musicians, bright individuals, etc, have a better chance to be rich than those who do not have such talents and have no means of generating income or wealth.

(iii) *Differences in wages:* Wages differs from one occupation to another. Therefore, workers who work in occupations which pay higher wages become richer as compared to those who work in the occupations which pay low wages.

(iv) *Luck and opportunities:* Some people may become rich through mere luck, such as winning games of chance such as the lottery.

(v) *Private ownership of the major means of production:* In the society where, there is private ownership of the major means of production, those who own the major means of production become more rich than those who do not own the major means of production.

(vi) *Social evils:* Some people, in the society, get wealth through illegal means like smuggling, selling drugs, theft and corruption.

(vii) *Education level:* More skilled labour earns higher wages than unskilled labour.

(viii) *Uneven income distribution:* If the distribution of income and wealth in the society is uneven, some group of people will become richer than other groups of people.

(x) *Tax structure:* When regressive tax system is used, it tends to affect the poor more than the rich, therefore, results in income inequalities.

(xi) *Favouritism:* In some countries, politicians tend to favour their respective areas/regions of origin by allocating more funds to such areas or by giving employment to their fellow tribes men. This leads to income inequalities among individuals and regions.

Advantages of Income inequalities

Income inequalities is necessary at early levels because of several factors as follows:

- It promotes individual initiative and hard work in a bid to enable the poor to improve their living standards.
- Income inequalities tend to improve labour relations, i.e. employer-employee relationship, so as to promote a conducive atmosphere for individual production, among the poor employees.
- Mobility of labour is encouraged, i.e. geographical and occupational, in an endeavour to raise income levels of the poor workers.
- It stimulates the government's effort to adopt policy programmes aimed at alleviating poverty in the society.

- Income inequalities encourage progressive taxation of the rich by the government, which consequently enhances the provision of services for the poor.
- Harmony and respect in the society is also promoted by income inequalities. The poor tend to respect the rich.
- An income inequality is a source of cheap labour, which is provided by the poor.
- Income inequalities results into social balance and stability among individuals. Since inequalities are caused by natural abilities, people's incomes can never be the same.
- It stimulates effort among the poor members of the society so as to catch up with the rich.
- The poor people, who tend to consume rather than save, give chance to the rich who tend to save more to invest and accumulate capital. This leads to increase the investments in the economy.

Disadvantages/Demerits of Income Inequalities

Income inequalities has the following disadvantages:

- Income inequalities result into political instabilities, which might be incited by the poor majority.
- Poverty, especially in the rural areas, could lead to rural to urban migration, in a bid to seek for employment opportunities and better economic welfare.
- Inequalities in income distribution retard efficiency of human efforts among the poor, since they tend to become frustrated.
- The poor are often disguised and denied social justice and equality. They may not afford the basic necessities of life like shelter, food, education, clothing, etc.
- Poor income distribution discourages production investments to meet the needs of the poor, since the poor tend to "cast fewer votes" due to their low purchasing power.
- Income inequalities may lead to brain-drain, especially in developing nations, since the educated people from LDCs tend to migrate to developed countries in search of "greener pastures". This will create a manpower gap in LDCs.
- It promotes undesirable behaviours like theft, crime, prostitution, and corruption among the poor, so as to survive.
- It leads to exploitation and domination of the poor by the rich. The rich will become richer as the poor remain poor and even made poorer and miserable.
- Income inequalities create social tension and conflicts between the poor and the rich. This may lead to disharmony between these social classes and among regions.
- Widespread poverty tends to lead to a psychological discouragement to work hard. Confidence, self-esteem and respect are lost among the poor. This can be detrimental to the contribution of human resource to the national development.
- Income inequalities may result into regional, inter and intra-sectoral dualism in the country an equal establishment.
- It encourages the inflow of foreigners, who may not have interests in the domestic economy. This will lead to excessive capital flight/capital outflow in form of profit repatriation.
- The government revenue from taxation is likely to decline, if the majority of the people are poor.
- Decline in aggregate demand: Where the majority are poor, aggregate demand is likely to be low. This affects production and employment levels in the economy.
- Poor distribution of income retards economic growth and development.

Measures of Reducing Income Inequalities

Income inequalities can be reduced by using the following measures:

- *Progressive tax:* This is a system of tax in which the rich are taxed more than the poor .This help to reduce the income gap between the rich and the poor.
- *Minimum wage legislation:* In order to reduce income inequalities, the government provides, by the law, for every employer to pay a minimum wage. Employees are paid salaries or wages not less than the minimum stated by the government in its annual budget.
- *Equal opportunities:* In this measure, the government provides equal opportunities for all citizens in all the regions, for adequate and affordable social services such as education.
- *Subsidies and transfer payments:* The government can provide subsidies to the poor in terms of inputs such as fertilizers to peasants, allowances to students from poor families, and subsidies to industries which produce essential goods that are consumed by the majority.
- *Micro-financing:* These are small scale credits that are provided to the poor groups in the society to enable them establish small scale businesses that can support them and their families.
- *Price control and stabilization:* The government should make sure that the prices of goods produced by the poor people, such as peasants and small traders, remain stable to avoid further decline in the income of these groups.
- *Mass employment:* This can be encouraged through labour intensive techniques of production so that the majority of the population become able to earn income.
- *Decentralization of industries:* The government can reduce income inequalities by establishing infrastructure in all regions of the country in order to encourage of investments in all the regions within the country.
- *Control ownership of the major means of production:* The government can control ownership of the major means of production to ensure that the majority of the people in the country have access to the major means of production such as land.

Methods of Showing Income Inequalities

Income inequalities in the society can be shown by using the *Lorenz Curve.*

The Lorenz Curve is a locus of points which shows cumulative percentage of population and cumulative percentage of income or wealth. The Lorenz curve gives a visual expression of how equal or uneven income distribution is:

- When the income is equally distributed, it is shown by a diagonal line, known as the *line of perfect equality*
- An income inequality is shown by a convex curve drawn, to the right from the line of perfect equality.
- The closer the curve to the line of perfect equality, the lower the income inequalities.
- When the Lorenz curve is far from the line of perfect equality, it shows a higher income inequality.

Table 1.8: Income distribution in 1929 and 1979

Quantity of households	1929		1979	
	Share of income in $	**Cumulative% of income in $**	**Share of income in $**	**Cumulative% of income in $**
Lowest fifth	3.9	3.9	5.3	5.3
Second fifth	8.6	12.5	11.6	16.9
Third fifth	13.8	26.3	17.5	34.4
Four fifth	19.3	45.6	24.1	58.5
Highest fifth	54.4	100	41.5	100.00

The Lorenz curve from the above data can be drawn as follows:

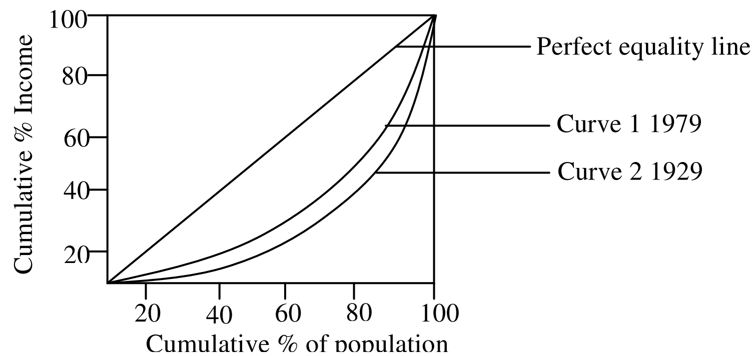


Figure 1.7: Lorenz curves for 1979 and 1929

In figure 1.7 above,
Curve 1 shows a smaller income inequality than curve 2, because it is closer to the line of perfect equality. This implies that, an in1929, income inequality was higher than in 1979.

Review Questions

1 (a) What is the National Income?
  (b) Describe three methods of calculating the national income
2. Explain the problems of calculating the national income.
3. What are the weaknesses of using income per capita when comparing the living standards of the people in different countries?
4. Given the following data:
   Gross national product at market price = 20 million
   Income from abroad = 4 million
   Gross domestic product at factor cost =10 million
   Net indirect tax = 2 million
   Indirect tax = 1.5 million
   Net national product at market price = 15 million
   Find the following
   (i) Depreciation
   (ii) Net factor income from abroad
   (iii) Subsidies

5. Differentiate between the Gross National Product at market price and the Gross National Product at factor cost.
6. What are the causes of income inequalities?
7. (a) Derive a simple investment multiplier.
   (b) Given the followings:
      (i) Marginal Propensity to Consume (MPC) = 0.5
      (ii) Marginal Propensity to Save (MPS) = 0.4
      Find the multiplier.
8. By using a numerical example, show how a multiplier operates.
9. What are the limitations of multiplier in Africa?
10. Discuss how the multiplier interacts with the accelerator to increase the size of the national income.
11. Given the following information:
    The national income of country X = $ 20 million
    Consumption = $ 6 million
    Marginal Propensity to Consume = 0.6
    Calculate the effect on the national income, if investment is increased by $ 5 million.
12. Given the following income distribution:

YEAR	1 9 2 9		1 9 7 9	
Quantity of household	Share of income	Cumulative % of income	Share of income	Cumulative % of income
Lowest fifth	3.9 m	-	5.3	-
Second fifth	8.6 m	-	11.6	-
Third fifth	13.8 m	-	17.5	-
Fourth fifth	19.3 m	-	24.1	-
Highest fifth	54.4 m	-	41.5	-

    Draw the Lorenz Curve for the year 1929 and 1979, and interpret your observations.
13. Discuss the concepts *voluntary* and *involuntary unemployment*.
14. What is *under-employment* and *over-employment*?

CHAPTER TWO

PUBLIC FINANCE

Public finance is part of economics policy which is concerned with the way the government obtains revenue and spends it, so as to improve and promote the economic and social welfare of the citizens.

The Need and Role of the Public Finance

Public finance has the following roles:

- The governments need to finance certain public utilities i.e. public services such as, security, power, education, etc. This requires money which has to be raised through public finance.
- Through public spending, the government can redistribute income and wealth more evenly.
- The government has to participate and effectively contribute to the production, marketing and distribution of goods and services. This can only be successful through the required capital which is raised from public finance.
- The productive infrastructure such as roads, railways, communication systems, etc, must be properly maintained. Public finance should provide sufficient funds to maintain and develop the necessary infrastructure.
- Public finance enables the government to establish and run risky projects that require large capital, e.g. Civil Aviation.
- Mobility of labour is quite important. Public finance, through wage policies, enables the government to distribute the available labour force, so as to increase efficiency.
- Research units. The government, through public finance, is able to establish research units.
- Public finance is important in the process of economic developments, because it is a supplement to the limited private capital.
- The private sectors enterprises need to be correctly directed. Public finance enables the government to influence and guide the level and direction of the private sectors economic activities.
- In the absence of privatization and liberalization programmes, public finance sets up the state enterprises, supplies funds for improvement, modernization and expansion of various productive projects in the economy.
- Domestic resource exploitation. Public finance enables the government to exploit domestic natural resources e.g. fisheries, minerals, forests, etc, which might otherwise be idle.

Functions of the government

The government performs various functions which necessitates it to have funds. These functions are as follows:

(a) *Administrative Functions:* This is the day-to-day activities running of the government through established structures in the civil service.

(b) *Protection Functions:* In this function, the government needs funds to maintain peace and security.
(c) *Social Functions:* In this function, the government needs funds to provide the population with social services such as education and health.
(d) *Development Functions:* In this function, the government needs funds to finance various development projects such as roads, railways, research, irrigation, electricity and other infrastructural needs.

Objectives of the Government

The objective of the government is to achieve the following:

(i) *To create full employment:* In this objective, the government makes sure that all resources, including human and non-human resources, are fully employed.
(ii) *Control of inflation:* Inflation has adverse effects to the economy. Therefore, it is the responsibility of the government to put it under control.
(iii) *To achieve economic growth:* The government must ensure that the economy grows at the desired rate.
(iv) *To raise the living standard:* The government must ensure that the standards of living of its citizens are improved.
(v) *To have a balance of payment:* The government must ensure that its balance of payments is neither in deficit nor in surpluses, because both have negative effects to the economy.
(vi) *To achieve social and political stability:* The government must ensure that law and order is maintained in the country.

Divisions of Public Finance

Public finance is divided into four dominions, namely:

- The government revenues
- The government expenditures
- National budget
- Public debts

The government Revenues

This refers to the revenues that are received by the government from various sources to meet expenditures.

Sources of the Government Revenues

The government collects money from internal and external sources.

1. *Internal Sources*

The following are internal sources of the government revenues:

(a) *Tax:* A tax is a compulsory payment by individuals and firms to the government.
(b) *Fees:* These are payments made by the users of public services to the government like cost sharing in health and education.
(c) *Fines:* These are penalties imposed by the government against law breakers.
(d) *Borrowing:* The government can borrow money from banks or the public by selling sureties.
(e) *Profit:* The government can get revenues from profit realized from the public enterprises.

(f) *Selling of Public Enterprises:* The government gets revenues by selling or privatizing public enterprises and firms.

2. *External Sources*

(a) *Borrowing from international financial institutions and donor countries*
(b) *Grants and gifts*
(c) *Foreign investments*

Principles or Canons of a Good Tax

- *Equity:* A good tax must be equitable or fair, that is the amount of tax must be proportional to the level of income. People with higher income must be taxed higher amounts than people with lower incomes, i.e. pay as you earn (PAYE).
- *Convenience:* The methods of tax collection must be convenient to both the tax payers and tax collectors.
- *Certainty:* The tax payers must be aware of exactly how much to pay, and the tax collectors, likewise, must also know how much to collect.
- *Economy:* The cost of collecting tax should be relatively low, and the government should receive all the income collected.
- *Productive efficiency:* A good tax should stimulate the establishment of resources and must not discourage allocation of resources.
- *Difficult of evasion:* A good tax must be difficult to evade by the tax payers.

Systems of taxation

These are organized methods through which tax is levied. There are three systems of taxation:

- Progressive tax system
- Proportional tax system
- Regressive tax system

- *Progressive Tax System:* This is a system of taxation in which the amount of tax depends on the level of income (PAYE) i.e. the amount of tax levied is proportional to the level of income increase. This system is very useful in reducing income inequalities among income earners.

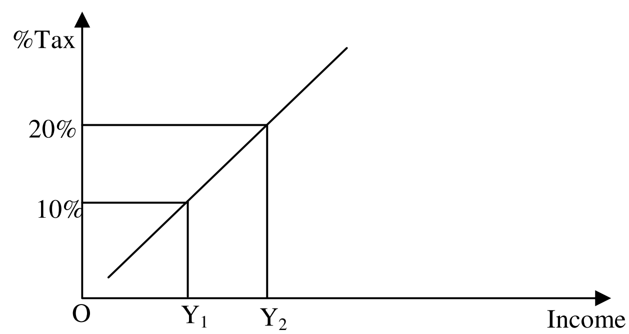


Figure 2.1: Progressive tax system

In figure 6: 1 above, at a lower income, Y1, the amount of tax is 10%. At a higher income, Y2, the percentage of tax is 20.

- *Proportional Tax System:* This is a system of tax in which the percentage of tax is the same for all the levels of incomes. For example, when a person who earns Tshs. 20000 per month pays 10% of the income as tax, and a person who earns Tshs.30000 per month also pays 10% of the income as tax.

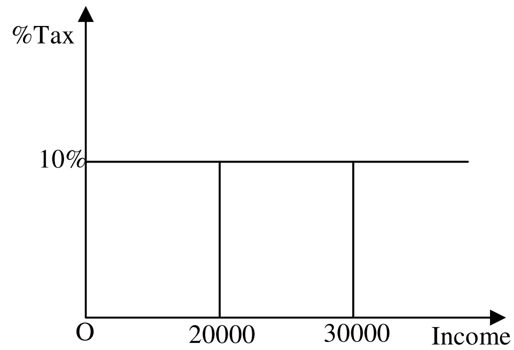


Figure: 2.2: Proportional tax system

In figure 2.2 above, income levels of 20000/= and 30000/= are charged the same 10% of the income as tax.

- *Regressive tax system:* This is a system of tax in which the percentage of tax levied varies inversely with the tax payer's income. The higher the income, the lower the proportion of the income is paid as tax and the lower the income, the higher the proportion of the income is paid as tax. This kind of tax applies when indirect tax is imposed on goods and services which are consumed by both the high income earners and the low income earners. When the poor person purchases a commodity, the amount of indirect tax she/he pays is the same as that that paid by a rich person. In this case, the tax paid is said to be regressive, because the poor person pays a larger proportion of his/her income than the rich person.

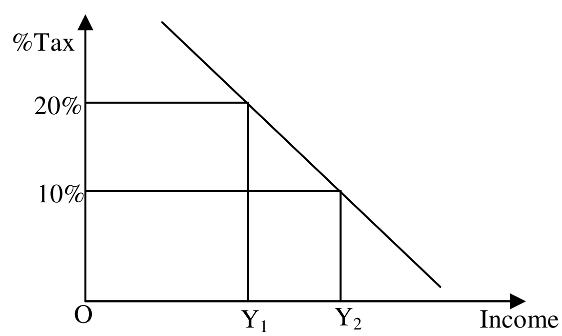


Figure: 2.3: Regressive tax system

In figure 2.3 above, a higher percentage of tax, 20%, is imposed to a lower income level, Y1, and a lower percentage of tax, 10%, is imposed to a higher level of income Y2.

Why is Regressive Tax Justified?

Regressive tax is justified on the following grounds:

- The low income earners are the main consumers of the public goods which are provided by the government, since most of the rich people consume private services.

- The rich people are the investors; therefore, they have bigger contribution to the national economy than the poor people.

Types of Taxes

There are two main types of tax
A. *Direct tax* and
B. *Indirect tax*.

A: *Direct tax*

This is a type of tax which is imposed on people's income. The following are the examples of direct taxes are:

(i) *Graduated Tax:* This is the tax which is levied on one's income, mostly for the employed income earners, on wages or salaries.
(ii) *Pay as You Earn Tax:* This is paid by means of directly deducting from one's salary, by the employer, who regularly sends the collection to the tax authority.
(iii) *Corporation Taxes:* These are taxes imposed by the government and paid by the companies with respect to profits, turnover or percentage of total sales.
(iv) *Property Tax:* A property tax is assessed by the local authorities on property, such as house, land, etc.
(v) *Estate or Death Duty:* This is assessed on the wealth of person at the time of death.
(vi) *Surtax:* This is payable by the rich people in the society .It is usually assessed for those who earn beyond a certain level of income. It is paid on top of the graduated tax.
(v) *Capital Gain Tax:* This occurs when the value of capital asset increases, especially when the asset is being sold .It is imposed on assets which have appreciated.

Advantages of direct tax

Direct tax has several advantages over indirect tax:

- It is easy to tell in advance the amount to be paid and collected as tax from individuals and firms, because it is deducted directly from their income.
- This type of tax is very helpful in reducing the income gap between the rich and the poor people, since it applies the pay as you earn rule (PAYE).
- Direct tax is also helpful in controlling the demand pull inflation, since when direct tax is imposed, the disposable income of the income earners decline, which leads to a decrease in their purchasing power, hence control of demand-pull inflation
- Economical in collection. This type of tax is economical to collect in the sense that the cost of collection is proportionally low compared to the revenues collected.

Disadvantages of Direct Tax

- High direct tax can discourage people from working hard. This type of tax can discourage people from working hard, because people will have the feeling that, if they work hard and earn more income, they are liable to pay more tax.
- This type of tax discourages savings, because it reduces the disposable income of the income earners. Decrease in savings may discourage investments and economic growth.
- It discourages investments in case it is imposed on profits which results from investments. Investors are discouraged, in this case, because they are aware that the profit they earn would be taxed.

- This type of tax can result into tax evasion (tax avoidance). This happens when tax payers hide some information about their income.
- Direct tax is discriminatory in nature since it is paid by few people in the society; only those who earn income from formal sectors.
- Direct tax has high incidences of tax, that is, the burden of direct tax falls wholly to the tax payer.
- Reduce the disposable income of the income earners, thus reducing their purchasing power.
- Easy to avoid since people might under state their income.

B: *Indirect Taxes*

It is a type of tax which is imposed on goods and services. Examples of indirect tax are:

(i) *Custom duties:* These are taxes collected at the borders or port, by customs duties officials.

(ii) *Octoroi Tax:* It is a tax imposed on goods which are on transit through the territory of another country.

(iii) *Sumptuary Tax:* It is a tax imposed on the consumption of certain commodities in order to discourage their consumption.

(iv) *Export Duties:* These are taxes on exports, probably meant to discourage the export of certain goods

(v) *Excise Duty:* These are sales or purchase taxes imposed on goods that are locally produced and domestically consumed.

(vi) *Value Added Tax:* This is the consumption/expenditure tax levied or assessed on the value of a commodity in each of the stages of production, exchange and distribution.

Advantages of Indirect Taxes

Indirect tax has the following advantages over direct taxes:

- Effects of indirect taxation are spread to all the consumers, that is, all consumers pay indirect tax.
- More revenue is collected in this type of tax than in direct tax, because indirect tax is paid by everybody who consumes goods and services. It means that it has a wider tax base (source) than a direct tax.
- It is very difficult to evade paying indirect tax, because it is imposed on every purchase of goods and services.
- It is paid unknowingly, by the tax payers; hence it is less painful to the tax payer and does not discourage people to work hard.
- Unlike the direct tax, indirect tax is paid by final consumers. In this case, producers are not affected directly by this type of tax. Unlike direct tax, indirect tax does not discourage investments.
- Indirect taxes guide the allocation of resources in the country by increasing savings and priority areas, and it discourages investments in non-priority areas of production.
- They help to stabilize the economy. High import duties help to control imports, thus reduce balance of payment problems and improve terms of trade of the country.
- It has a wider coverage than direct tax, since it is paid by all the consumers of the goods and services on which the tax has been levied.
- It can be used by the government to either encourage or discourage the production and consumption of certain commodities.

Disadvantage of Indirect Tax

- Indirect tax is regressive in nature, because the low income earners pay a larger proportion of their income, as tax, than the higher income earners.
- It is inflationary in nature, because when it is imposed, it increases the cost of production and prices (it leads into a cost-push inflation)
- It is inconvenient. It is very difficult to collect this tax, since a lot of information is needed from business people including follow ups.
- It is not economical. There is a lot of costs of administering the collection of this type of tax. This makes this type of tax to be uneconomical to collect.
- The cost of collection and administering may be higher than the amount collected.
- Indirect taxes may have bias against certain groups of consumers like smokers and alcoholic beverage consumers, these groups of consumers are heavily taxed.
- High indirect tax may discourage demand, because it leads to increase in the prices of goods.
- Misallocation of resources may occur, since investors may opt to invest in industries which are less taxed, and leave industries which are more productive and important to the economy, but are heavily taxed.

Value Added Tax (VAT)

What is VAT?

VAT is an indirect tax which is levied on the supply of any taxable goods and / or services by any business that is registered for VAT purposes. These goods/services must be sold or supplied in the course of or for the furtherance of the businesses. VAT is also levied on the importation of goods and services (*Tanzania revenue Authority VAT general guide April 2007)*

How does VAT work?

Each registered person in the chain between the first supplier and the final purchaser/user is charged tax on taxable supplies made to him (input tax), and charges tax on taxable supplies made by him (output tax). They pay over to the Commissioner the excess of output tax over input tax, or recovers the excess of input tax over output tax from the Commissioner. The broad effect of the scheme is that, businesses are not affected by VAT except in so far as they are required to administer it, and the burden of the tax falls on the last purchaser/final consumer.

The following example illustrates how VAT is charged as goods move from one registered person to the next in the manufacturing and distribution chain, until they reach the final user. It is assumed, for the purposes of illustrations that the manufacturer makes no purchase and that VAT is charged and accounted for at the rate of 20%:

Table 2.1: VAT General Guide

Business	VAT return	VAT due
1. Manufacturer Selling price Tshs. 1000/= VAT (20%)…..200/= Tax invoice value Tshs. 1,200/=	Tax on sales(output tax)Tshs. 200/= less tax on purchases (input tax (0) VAT payable Tshs. 200/=	Tshs. 200/=
2. Wholesaler Selling price Tshs. 1400/= VAT 280/= Tax invoice 1680/=	Tax on sales (output tax) Tshs. 280/= less Tax on purchases (input tax) 200/= VAT payable Tshs. 80/=	Tshs. 80
3. Retailer Selling price Tshs. 2000/= VAT 400/= Tax invoice value 2400/=	Tax on sales (output tax) Tshs. 400/= less Tax on purchases (input tax) 280/= VAT payable	Tshs. 120/=
4. Total tax		400/=

Source: Tanzania Revenue Authority (*VAT general guide April 2007*)

Who collects VAT?
VAT is collected by businesses and organizations that are registered by the commissioner of tax. A business or organization, which is registered or required to be registered for VAT is called a taxable person.

What are taxable supplies?
Taxable supplies are the supplies of goods or services made by VAT registered persons in the course of or for the furtherance of the business.

Taxable supplies include the following:

- The sale or delivery of taxable goods by taxable persons to another person, including imports.
- The sale or provision of taxable services by a taxable person to another person.
- The appropriation, by a registered person, of taxable goods for his personal use or for use by others like the family or friends;
  - The making of gifts or loans of any taxable goods in the course of business.
  - The letting of taxable goods on hire, leasing or other transfers.
  - Barter trade, i.e. exchange of goods for other goods.

What are goods?
(a) Tangible movable things - goods in the ordinary sense of the word.
(b) Immovable property - land, buildings, etc.

Note: Money is not goods for the purpose of VAT

What are services?

Services include:

(i) Professional and commercial services - services include accountants, engineers, architects, lawyers, secretarial, electricians, plumbers, builders, motor vehicle repairs, employment agencies, advertising agencies, transport services etc.

(ii) Intellectual property rights - patents, trademarks, copyrights know - how etc.
Any other supply, which is neither goods nor money.

The role of the business people registered with VAT

The business people who are registered with VAT are supposed to do the following:

(i) Records: Proper and adequate records must be kept to enable a responsible revenue office to check on the self-assessment of their VAT liability. Records should be kept for a minimum of five years.

(ii) Tax invoices: A VAT registered person must provide a tax invoice to another VAT, registered, person at the time of selling taxable goods or services.

(iii) Debit and credit Notes: These must be provided where required.

(iv) VAT Account: For each 'tax period', they must keep a summary of the totals of their output tax and input tax.

(v) Returns: A VAT return must be completed and submitted to the tax Commissioner by the due date, i.e. the last working day of the month after the month of business.

(vi) Accounting for VAT payable: Tax payable must be calculated and accounted for by the "due date".

(vii) Changes of business particulars: Whenever there are changes in their business circumstances, they should notify the tax Commissioner within thirty days of such change.

(viii) Retained Assets on cancellation of Registration:
VAT must be accounted for on any assets of a registered person retained upon ceasing to be registered.

How do business people account for VAT?

VAT is normally accounted for at the time of supply, i.e. VAT is generally accounted for when:

- Tax invoice for the supply is issued, or
- Payment is received for the supply or part of the supply, or
- The goods are removed from the premises or from other premise where the goods are under your control, or the goods are made available to the person to whom they are supplied or when services are rendered or performed; whichever occurs first.

What is a tax period?

A tax period is the length of time covered by VAT return i.e. one calendar month.

Advantages of Value Added Tax (VAT)

- It is a broad-based tax which falls over a wide range of consumers through their consumption expenditure.
- VAT promotes efficiency in production since firms cannot be taxed in case of losses or profits, because the tax is based on the gross value produced.
- The tax has neutral distributive effects, and can guide the allocation of resources.
- VAT is simple in administration. The tax liability can easily be assessed and the tax revenue effectively collected.

- It minimizes tax evasion, since each production unit accounts for taxes paid by other firms from which inputs are obtained, so as to avoid tax payment by one individual firm. This cross auditing enables tax authorities to avoid the possible occurrences of tax evasion.
- It enables some goods to enjoy tax exemption, and yet uniform taxes are assessed on other goods.
- VAT widens the tax base, because the tax has to be ultimately paid by the final consumers.
- It is non-discriminative to factors of production, since they are equally taxed.
- It is quite easy to calculate among business people, if they keep and maintain proper records.

Disadvantages of VAT

- There is need for appropriate record keeping and frequent cross-checking, which is not common in LDC's.
- VAT is not popular, especially among the illiterate and, therefore cases of evasion are likely to occur.
- This tax tends to affect small firms and consumers, since it is often proportional. Large scale enterprises are definitely less affected.
- The tax is regressive, since all taxable goods and services are treated equally.
- The VAT is complicated and difficult to be understood in some countries, like Tanzania, it calls for massive education to create awareness among the citizens.
- It is a consumption tax; therefore it may affect the level of consumption in the country.
- Usually, tax liabilities are not submitted to the tax authorities and yet this could result into difficulties in tax collection.
- The public is often ignorant about the commodities that are zero rated and exempted from the VAT system.
- There are sometimes delays in submission of revenue by tax collectors and payers to the government.

Why the government of Tanzania introduced VAT?

The government of Tanzania introduced VAT due to the following reasons:

- To improve tax administration in the country.
- To increase the percentage of taxable Gross domestic product.
- To widen the tax base and, consequently, reduce the tax rate, so as to achieve equality, tax compliance and minimize tax evasion
- To protect domestic industries against foreign competition.
- To minimize tariffs that affects her exports.

How VAT is computed?

V.A.T is only claimed and accounted for from registered tax payers /businessmen. VAT is usually remitted to Revenue Authority within a business period of a month, by the tax payers, at the time of purchase. VAT can only be offset on sales with purchases at each stage of supply. This is eventually met by the ultimate consumer. Therefore, the unregistered (the buyer) meets the tax in form of the final price of the commodity.

V.A.T payable = Output tax-Input tax.

Why should individuals and firms pay tax?

There are several reasons as to why taxes are imposed. Some of these reasons include;

(a) *Raising the government revenue:* The government impose taxes in order to get revenue that is necessary for meeting its expenditure on public services and administration of the government.

(b) *Income redistribution:* Taxes are imposed in order to reduce the income gap between the rich and the poor people in the society. The rich people are heavily taxed, and the income collected is used to uplift the poor in terms of providing them with public services.

(c) *Encourage investment and growth:* Tax on imports is aimed at discouraging imports, in order to stimulate domestic production.

(d) *To reduce deficit in the balance of payments:* Tariffs are imposed on imports in order to reduce imports and, therefore, reduce deficit in the balance of payments.

(e) *To discourage consumption of harmful products:* Tax is sometimes aimed at controlling the production and consumption of harmful products, such as cigarettes and beer.

(f) *To stabilize the economy:* Tax can also be imposed in order to control economic instabilities, such as inflation. During inflations, the government increases direct tax, in order to control excessive demand, and reduce indirect tax in order to reduce the prices of goods.

Incidence of Tax

This refers to the burden of paying tax. When tax is imposed, who actually pay the tax? Is it the producer, the consumer or both?

(i) *Case of direct tax:* For the case of direct tax, the whole incidence of tax goes to the tax payer i.e. the income earner. He/She has to pay the full amount of tax, since tax burden cannot be shifted to anyone else.

(ii) *Case of indirect tax:* For the case of indirect tax, the burden of tax depends upon the elasticity of demand for a commodity.

- *Tax on Goods with Perfectly inelastic Demand*: These are the goods which are demanded in the same quantity at all levels of price. In this case, the incidence of tax falls more heavily on the consumers, because the consumers buy the same amount at whichever the level of price.

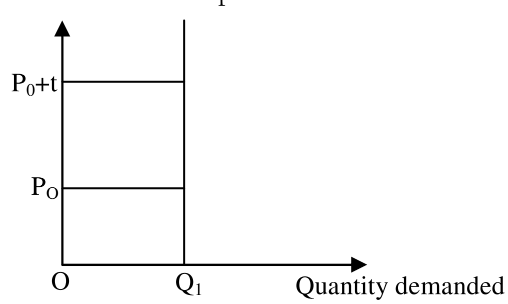


Figure: 2:4: Tax on goods with perfectly inelastic demand

In figure 2:4 above, before the imposition of tax, price was P_O, and the quantity demanded was Q_1, after the imposition of tax, the price increased to P_O+ t (where t is tax), but the quantity demanded remained the same at (Q1), therefore, the consumer shouldered the whole tax incidence.

- *Tax on goods with perfectly elastic demand:* These are the goods which are sold at the same price, whatever the quantity demanded.

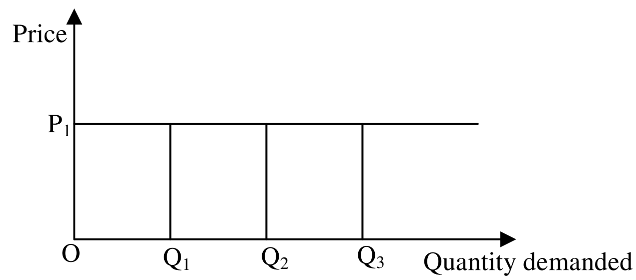


Figure 2.5: Tax on goods with perfectly elastic demand

In figure 2:5 above, the producer sells different amounts at the same price, P_1.So, when tax is imposed by the government, the producer will bear the whole amount of tax. Under this situation of perfect competition, the producer cannot influence the price of the commodity.

- *Tax on goods with inelastic demand:* These are the goods which the quantity demanded changes by a small proportion when price change. In this case, when tax is imposed, price increases by the amount of tax levied, but quantity demanded decrease by a small proportion. So, the tax burden goes to the consumers, because they will be buying almost the same amount, but at a higher price.

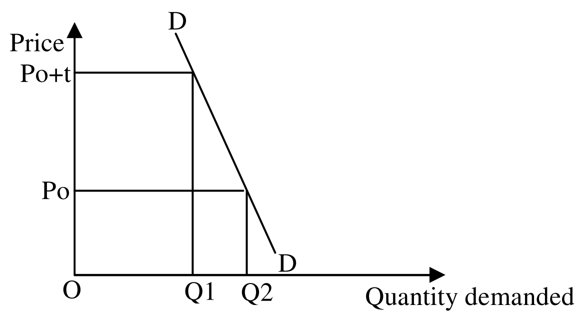


Figure 2.6: Tax on goods with inelastic demand

In figure 2:6 above, before the imposition of tax, the price was Po and the quantity demanded was Q1. After the imposition of tax, the price increased to Po+t, and the quantity demanded decreased by a small proportion to Q1. Hence, the consumers bear the burden of paying tax, since the quantity they demand decreased by a small amount when the price increased.

- *Tax on goods with elastic demand:* These are the goods which the quantity demanded changes by a small amount when the price changes. When tax is imposed, the price increase by the proportion of tax, resulting in a large decrease in the quantity demanded. The tax burden, therefore, fall more heavily on the producers because of the big decrease in the quantity demanded by the consumers.

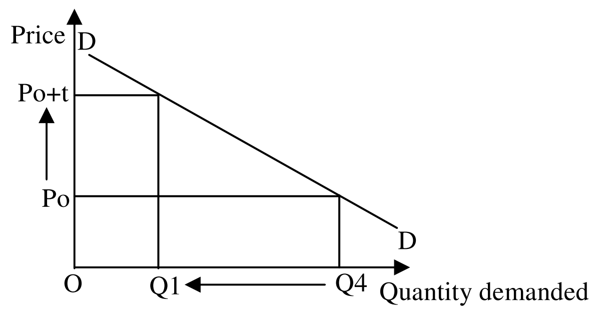


Figure 2.7: Tax on goods with elastic demand

In figure 2:7 above, an imposition of tax on a commodity resulted into an increase in the price of the commodity from Po to Po+t, and a large decrease in the quantity demanded from Q4 to Q1, hence a big burden to the producers due to the large fall in the quantity demanded and revenue.

Incidence of tax and systems of tax

The incidence of tax can also be discussed according to the systems of tax.

- *The case of progressive Tax:* In the case of progressive tax, the incidence of tax fall on both high income earners, and low income earners, because tax increases as income also increases.
- *The case of regressive Tax:* In this case of regressive tax, the incidence of tax falls more heavily on low class people because they pay a large proportion of their income, as tax, than the rich people.
- *The case of proportional Tax:* For the case of proportional tax, the burden of tax falls more heavily on the low income earners than the high income earners, since both these groups pay the same percentage of tax.

Economic effects of tax

Taxes have both negative and positive effects:

A. *Negative Effects*

The negative effects of taxes are as follows:

(i) *Discourages people from working hard:* Heavy direct tax discourages people from working hard, since it reduces their disposable income i.e. the amount of money that remains for consumption after the deductions of tax.

(ii) *Discourages savings:* Heavy direct tax reduces disposable income, hence the savings of the income earners.

(iii) *Discourages investment:* Large tax, on firm's profits, is a disincentive against the entrepreneurs to reinvest their profit in production.

(iv) *Diversion in allocation of resources:* Investors may deviate the allocation of resources from heavily taxed but more productive sectors, to less taxed and low productive sectors or to the production of illegal products, like cocaine, which are not taxed.

(v) *Tax may cause inflation:* Large income tax may animate workers to demand for more wages and, therefore, lead to demand-pull inflation. Likewise, large indirect tax is inflationary because, when imposed, it leads to an increase in the prices of goods and services.

B. ***Positive effects of taxes***

The positive effects of taxes are as follows:

(i) *It can be used to control inflation:* By increasing direct tax, the purchasing power of the people decrease. This may reduce demand-pull inflation.

(ii) *Discourage harmful products:* Certain kinds of indirect tax can be used to control the production and consumption of harmful products such as cigarettes.

(iii) *Control of balance of payment disequilibrium:* Heavy import duties can be a disincentive against imports and, therefore, a means of controlling the deficit in the balance of payments.

(iv) *Revenue generation:* Tax is an important rootstock of the government's revenues, that is, the government depend on tax for most of its revenues.

(v) *Redistribution of income:* Tax redistributes income by taking part of the income of the rich people. The government, therefore use the money collected to provide for social services to the poor people.

Taxable capacity

Taxable capacity is the ability of the tax payers to pay the tax assessed on them, and at the same time, retains a reasonable level of income to enable them live the life they are accustomed to. So, *taxable capacity* of a nation is the percentage GDP, which is within the capacity of the country to contribute to the public tax revenues. It can also be referred to as the ability of the nation to obtain, from the tax payers, the revenues necessary from the imposed taxes.

Factors affecting Taxable Capacity

The factors underlying taxable capacity are as follows:

- *Inflation:* This lowers the people's purchasing power; hence it greatly affects the taxable capacity, especially from indirect taxes.
- *The level of economic progress:* The taxable capacity is influenced by levels of economic development.
- *Population size:* The number of inhabitants can increase the taxable capacity and the amount of tax revenue to the government.
- *Income distribution:* Usually, equitable distribution of wealth leads to a less tax revenue as compared to a situation where the wealthy are more and accordingly taxed. Political stability increases the taxable capacity, since the public is confident due to the conducive environment.
- *Attitude of the taxpayers:* A positive attitude towards development will increase the taxation potential among the people and vice-versa.
- *The tax procedure:* An appropriate tax procedure or collection methods will promote tax diversification and comprehensive taxes, which will expand the tax revenue.
- *The objective of taxation:* There is no doubt that the tax revenue/capacity will increase if there are specific aims for which the revenue is directed. For example, if it is meant to promote education, culture, industrialization, health, poverty eradication, tourism, sports etc.
- *The level of income:* The stability of income will generate more tax revenue and increase production, and vice-versa.

- *Reduction of conservative tendencies:* Traditionalism and conservatism may hinder the taxable capacity of the country while mordernization and liberalisation improves taxable capacity.

Why is the taxable capacity low in LDCs?

The taxable capacity is limited by the following of factors:

- Political limits. For political reasons, the governments of LDCs often limit the taxable level to a reasonable extent in order to gain popularity.
- The prevailing low levels of income among the people who are predominantly subsistence producers cannot boost the taxable capacity in LDCs.
- In developing countries, cases of tax evasion and avoidance are common, and this cannot expand the taxable capacity.
- Corruption. The taxable capacity is also limited by the corrupt tax assessors and collectors.
- The size of production. The size and, therefore, the taxable earning of enterprises are quite limited.
- Transportation bottlenecks. Collection of the desired/targeted tax revenues is further hampered by inadequate transport, because some areas are still remote.
- Language limitation. The diversity of languages among the rural communities often poses a serious communication problem, especially between he tax authority payers.
- The taxable capacity, in LDCs, is further limited by lack of proper record-keeping, upon which taxation is based.
- The fear to interfere with international trade also tends to limit the level of taxation in developing countries.
- The taxable capacity, in LDCs, is further affected by some cases of tax exemption.
- The rampant unemployment also affects the taxable capacity in LDCs, since this would imply limited sources of income.
- Regressive taxation. The taxable level or capacity is limited and affected by the regressive nature of taxation in LDCs, which mostly affect the poor.
- Inflation. This also scares the government from increasing taxes, since during an inflationary period, people's real income tend to fall.
- Smuggling. Rampant smuggling of both products and finance, to neighbouring countries, also affects the volume of tax revenues collected.
- In developing countries, taxable capacity is also limited by the prevailing unclear social, political, commercial and institutional frameworks.
- In most LDCs, including Tanzania, the agricultural sector is dominant. This implies that there are few industries from which adequate tax revenues can be collected.
- High population growth rates. High population lowers the taxable income, because of the high dependency ratio.
- The need to attract foreign investors, who are crucial for national development. The government has no choice but to offer tax relief, tax rebates, tax holidays, etc, in order to encourage investors foreign. This, too, may lower the taxable capacity.
- The shift from the traditional sectors to the informal sectors, whose activities are quite difficult to determine, makes it hard to determine appropriate taxes that should be imposed on them.
- The taxable capacity is further limited due to the narrow definition of some illegal activities, such as smuggling, prostitution, local brewing, private student’s tuitions etc.

Measures that can be adopted to widen the tax base and taxable capacity

There are many ways of improving the country's tax base and taxable capacity as follows:

- The government should improve its administrative machineries as far as tax collection is concerned, with an aim to minimize tax evasion and avoidance.
- Income generating activities should be encouraged, especially in rural areas, to provide opportunities for employment so as to expand the nation's taxable capacity.
- Diversification is further encouraged so as to expand avenues for the taxable potentials.
- Taxes on imports should be increased, especially on luxury items, so as to increase the amount of tax revenues.
- Reduction of income inequalities. The existing income disparities tend to lower the taxation potentials. The government is, therefore, urged to reduce income inequalities among most of the sections of the society, so as to expand the tax base.
- Education. There is need for education and awareness among the general public about the importance of taxation for national development.
- Specific institution, such as the TRA, should be put in place with considerable degree of autonomy to review the loopholes in tax collections, so as to raise the required tax revenues for the state.
- Improvement in economic activities should be enhanced, e.g. in the manufacturing sectors, informal employments, monetary expansions, etc, so as to raise the level of tax collection.
- Tax diversity. New taxes have to be introduced, like VAT, the land tax, etc, in order to widen the tax base.
- Fight corruption. Measures against corruption need to be greatly strengthened, e.g. through the Inspector General of the government, The Public Accounts Committee, the general Public, the press, etc.
- Adequate facilities to easily enhance the process of tax collection. There is need to acquire the necessary operational facilities like transport; computers to store the required tax information, etc so as to improve the efficiency in tax collection.
- A comprehensive tax payer's data. This can enables survey on tax payers, so that the tax collectors are kept in constant touch with the potential tax payers. This guides tax policy formulation and tax actions designed to achieve an effective policy on taxation.
- The tax base can further be improved by constant review of the existing tax structures, policies and programmes, so that they become compatible with the required targets.

THE GOVERNMENT EXPENDITURES

This refers to the spending of the government in various areas.

Types of The government Expenditures

The government expenditures can be categorized into the following groups:

(i) *Recurrent Expenditures:* This refers to the government spending on public consumption, such as education, health, maintenance of peace and security, salaries to civil servants, etc.

(ii) *Development Expenditures:* Refers to the government expenditures on development projects, such as the construction of roads, railways, communication networks and subsidies to economic sectors like agriculture.

Objectives of the government expenditures

The government expenditures are intended to meet the following objectives:

- To provide essential goods and services to the public, such as education and health services.
- Regulation of economic activities for the public interest. For example, control of monopoly.
- Influence allocation of resources in order to improve efficiency. For example, providing subsidies to small scale firms.
- Redistribution of income by providing loans and free social services to the poor.
- Stabilization of the economy, for example, controlling unemployment problems by increasing expenditures on economic and social services, which help to stimulate investments.

NATIONAL BUDGET

The national budget refers to the estimates of the government revenues and expenditures in a given year. In Tanzania, the national budget is presented to the national assembly, by the Minister of finance, in June each year. The minister makes a review of the government revenues and expenditures for the previous year, and makes forecast of the government revenues and expenditures for the coming financial year. The budget starts to be implemented after it has been approved by the national assembly.

Types of National Budget

There are three types of national budget:

(a) ***Surplus Budget***

A surplus budget is a budget in which the collected revenue is greater than the estimated expenditures. To achieve a surplus budget, the government increases the tax rates. Therefore, surplus budget reduces the purchasing power and investments.

Uses of the Surplus Budget

The surplus budget has the following uses:

(i) *To correct inflation:* The surplus budget can be used to control inflation because of the high tax rate, which reduces disposable income and the purchasing power.
(ii) *Correct balance of payments problems:* By increasing tax on imports, the surplus budget reduces the volume of imports and, thus controls deficit in the balance of payments.
(iii) *Discourages the consumption of harmful products:* Increase in tax rate, may also control the consumption of harmful products.
(iv) *To pay debts:* The surplus budget may be used to pay the government debts

Surplus budgeting

A surplus budgeting occurs when the government plans to spend less than the revenue available in a given financial year.

Aims and objectives of surplus budgeting

Surplus budgeting aims at achieving the following objectives:

- To reduce aggregate demand, so as to curb inflation.
- To finance development programmes in the country.

- A surplus budget also aims at accumulating resources/funds for the purposes of future investment.
- To reduce money in circulation.
- Enables the nation to give grants to other countries.
- It enables the establishment of development projects, within and outside the country.

However, a surplus budget may lead to:
- A depression in the economy.
- Excessive taxation of the people.
- Unemployment due to lack of incentives to save and invest.
- A decrease in money supply.
- Inadequate/insufficient aggregate demand due to high levels of taxation

(b) ***Deficit Budget***

A deficit budget is a budget in which the estimated the government revenues fall short of the estimated the government expenditures. A deficit budget has the following effects.
(i) It stimulates consumption and investments due to low tax.
(ii) It stimulates recovery from a recession.

Deficit Financing

Deficit financing occurs when the government planned expenditure is estimated to be in excess to the expected revenue.

Aims of Deficit Financing

Deficit financing aims at:
(i) Reducing the burden of taxation from the people.
(ii) Increasing the level of supply.
(iii) Increasing the level of aggregate demand.
(iv) Encouraging savings among the general public.
(v) Curbing down deflation.
(vi) Stimulating the level of economic activity.
(vii) Encouraging borrowing, which may be a faster and cheaper way of financing the government projects.
(viii) Lifting the economy from a slump or depression.

Causes of Budgetary Deficits in LDCs like Tanzania

Budgetary deficits are common deficits, basically arising from high the government expenditures and limited avenues of revenue collection.
- *Low taxable capacity*. This has not enabled LDCs, like Tanzania, to raise adequate revenues to balance their budget.
- *High levels of tax evasion and avoidance*. This, too, has limited prospects by the government to acquire the required revenues.
- *High population growth rates*. The ever increasing population in LDCs, like Tanzania, has led to high the government expenditures, thereby leading to budgetary deficits.
- *Uneven distribution of incomes*. This has further affected the taxation potential of the country leading to limited revenue.
- *Limited size of enterprises*. In Tanzania and indeed many LDCs, the sizes of the enterprises are still small and cannot raise enough tax revenues to balance the budget.

- *Corruption.* Budgetary deficits have been attributed to high rates of corruption among the politicians and some categories of the civil society. This has resulted into loss of revenues which would have otherwise been used to cover the budgetary needs.
- *Unemployment.* Rampant unemployment, coupled with the current retrenchment programmes, has worsened the situation, whereby a reasonable majority of the unemployed can hardly contribute revenues to the national treasury.
- *Poor planning.* There is often lack of proper planning, financial discipline and commitment, which has consequently led to wastage and misuse of public funds.
- *Price fluctuations.* Poor countries, being mainly dependent on agriculture, are subjected to price fluctuations. This will imply unpredictable revenues from the agricultural sector, which may consequently lead to deficits in the budget.
- High Marginal propensity to import. A lot of revenues in form of foreign exchange are spent to import necessities. This has always resulted into fewer revenues available to meet the domestic budgetary requirements.
- *Subsistence sector.* Poor countries are characterized by a relatively large subsistence sector, with low productivity, output and income (revenue).
- *Political reasons.* The taxation potential is further limited by the desire for some politicians to attain their political aspirations which greatly reduces the revenues base of the country.
- *Political instability.* Poor countries are entangled in political turmoil. This compels them to indulge into excessive expenditures to finance them (wars). However, a number of revenues are lost in the process.
- *High and unproductive expenditure by the government on its programmes have further adversely affected their revenue base,* causing temporary deficits in the budget.
- *Limited tax revenue due to poor methods of collection.* This has also led to reduced sources of finance to balance the budget.
- *Low savings and limited levels of capital accumulation have also affected the balancing of the budget,* because this limits the revenues potential of the country.
- *Poor national and global economic performance, unfavourable terms of trade, etc* has affected most LDCs' potential to earn the required revenue to finance their budgets.
- *Debt servicing.* Poor countries have a heavy debt burden, which often take a substantial proportion of their revenues which could have catered for the budgetary requirements.
- *Inflation.* The ever increasing price of goods and services has also affected the national budget. With inflation, it is quite difficult to predict future budgetary planning.
- *Unpredictable external funding has led to low and unreliable revenue,* which consequently affects the government budget.

(c) *Balanced Budget*
This is a budget in which the collected revenue is equal to the estimated expenditures.

Effects of a Balanced Budget
A balanced budget implies the following:
(i) That the government cannot borrow.
(ii) That there are stable prices, i.e. there is neither inflation nor deflation in the economy.
(iii) Money supply does not increase, i.e. it remains constant.
(iv) Aggregate demand does not change.

(v) The central bank cannot print any more money.
(vi) There is a constant level of employment.

Functions of the National Budget

The budget has the following main functions:

- *To redistribute income:* Through the national budget, the government may redistribute income by increasing expenditures in social services and providing subsidies to small scale businesses.
- *To correct deficit in the balance of payments:* Through the budget, the government can discourage imports and correct deficit in the balance of payments by increasing import duty.
- *To control inflation:* Through the budget, the government can control demand-pull inflation by increasing direct tax in order to reduce the purchasing power of the people.
- *To stimulate employment:* The government can create more employment opportunities through the budget by increasing expenditures on economic and social services, and providing subsidies to sectors which increase the level of employment such as agriculture. Also, by reducing tax on inputs in order to encourage investments and, therefore, create jobs.
- *Economic stabilization:* The budget can be used as an instrument for stabilizing the economy. For example, during economic recession, the government can reduce tax and increase expenditures to stimulate consumption and create employment.

(d) *Public Debts*

His refers to the money that the government owe individuals, firms within the country, or to institutions outside the country, and donor countries.

Classifications of Debts

Debts can be categorized into the following groups:

A: *Internal or External debts*

(i) *Internal Debts:* This refers to the money that the government owe institutions or individuals within the country.
(ii) *External Debts:* This refers to the money that the government owe to institutions outside the country or donor countries.

B: *Long Term and Short Term Debts*

(i) *Long Term Public Debts:* These are debts which are repaid after a long period of time, between 5 to 20 years.
(ii) *Short Term Debts:* These are debts which are repaid after a short period of time.

C: *Reproductive and Non Reproductive Debts*

(i) *Reproductive Debts:* These are debts in which the government use the money borrowed for productive expenditures, such as for the construction of roads or for the provision of other social services.
(ii) *Non-Reproductive Debts:* These are the debts in which the government use the money borrowed for non-productive expenditures, such as buying arms.

Causes and Justification of Public Debts

Quite often, the governments in less developed countries have greatly depended on borrowing. This can be justified by a number of reasons:

- *Inadequate tax revenue:* Poor countries incur debts because the revenues collected from taxes is insufficient to finance the all the government programmes. At times, the expected revenues tend to fluctuate.
- *To reduce the burden of taxation:* Borrowing is often resorted to as a means of reducing the tax burden from the people.
- *Overcome natural calamities:* Debts are also incurred to meet the unexpected occurrences such as floods, drought, etc.
- *Raising revenues:* The government incurs public debts so as to raise adequate revenue that is required for development purposes.
- *B.O.P deficit:* Public debts, especially external debts, are incurred in a bid to correct the B.O.P deficits which is common in LDCs.
- *Financing ambitious development plans:* The governments of poor nations tend to draw ambitions plans that are often financed through borrowing, e.g. road construction, industries, etc.
- *To attain economic growth:* Effective exploitation of the potential domestic resources needs to be financed so as to increase GNP. Therefore, public debts are inevitable in accomplishing this task.
- *Public debts are also incurred in order to enable LDCs to fill the manpower,* foreign exchange and savings gaps.
- *To balance the budget:* Public debts are incurred to help in covering unforeseen or unpredictable budgetary deficits which are common in developing countries.
- *Curbing economic depression:* Public debts are quite significant in raising production, aggregate demand, employment and the level of economic activities in general.
- *Debt servicing:* It is a common practice, by some developing nations to incur new debts in order to repay the old ones.
- *Political instability:* Some prevailing political turmoil in developing countries, especially in Africa, has greatly necessitated the government borrowing, hence incurring public debts.

Negative Consequences of Public Debts

Public debts have the following negative consequences:

- The volume of imports into the country tends to reduce. This is because of the high outflow of foreign exchange to repay the debts.
- The burden falls on the citizens, who are taxed to cover up for internal debts, such that the size of the debts may influence the level of taxation.
- The effect is great on the level of consumption because high taxes on individuals deprive them of consumption.
- The future generation is affected as a result of the debt incurred many years back, to finance services that it never enjoyed or will never enjoy.
- Debt repayment reduces expenditure on capital goods for investment and, thus, limited capital formation.
- Dead weight debts e.g. financing wars may prove to be inflationary and can affect the distribution of incomes, savings and investments.

- Wastage may be encouraged. Dead weight debts results into wastage of resources, especially at the time of repayment.
- Public debts encourage over-dependence on external sources; hence this does not promote the spirit of self-reliance.
- The debt incurred in form of tied aid is always accompanied with strings (conditions) attached which often conflict with the development programmes of the recipient country.
- B.O.P position. External borrowing tends to worsen the country's B.O.P position leading to severe B.O.P deficits.
- High administrative costs. In case of internal debt, the costs of debt redemption are quite high. This is made worse by the condition to pay a reasonable rate of the interest required.
- Unemployment, deteriorating living standards, etc are likely to occur, because the debts incurred tend to affect the level of investment and production.

Positive Consequences of Public Debts

The Public debts may have some positive consequences to the country.

- The debt incurred can lead to an increase in the GDP increase it is used appropriately to exploit and mobilize the domestic production for increased output.
- The debt, if it is reproductive in nature, is quite significant in increasing the government's revenues.
- More employment prospects can be generated, if the debt is a self-liquidating one, i.e. aimed at stimulating production activities.
- Increased foreign exchange earnings. More foreign revenues can come in, especially through borrowing from external sources, or when used to promote and expand the export sector.
- The debts incurred can expand the levels of production within the domestic economy, and this can generate economies of scale.
- Improve the standards of living. Public debts incurred can enable the production and importation of a wide variety of goods and services. This will, consequently, improve the standards of living of the people.
- The public debts (borrowings) tend to reduce political resistance to high taxation which is likely to be done by the citizens of developing countries.
- Borrowing is not deflationary; since it reduces the tax burden so as to increase people's consumption expenditure, and therefore aggregate demand.
- The public debts can reduce political instability, e.g. through borrowing to finance wars. A stable political atmosphere, there is no doubt, encourages production for development.
- Debt finance acquired can help to cover the manpower, savings investment gaps, for which poor nations tend to solicit for foreign aids.

Redemption of Public Debts/Management of Public Debts

This refers to attempts by the government to pay public debts. These attempts are as follows:

- Surplus budget: In this method, the government estimates more revenues than expenditures in the budget and use the surplus to pay debts.

- Sinking fund method: In this strategy, certain amount of money is invested in the bank, and after some years, the money increases through compound interests and the money generated through this interest is used to pay debts.
- By conversion: In which the government takes a new loan of lower interest to pay the previous debts.
- By repudiation: In which the government refuses to pay the debts
- Capital levy: In this method, the government imposes tax on assets such as buildings to generate more revenues for paying debts.
- Use of accumulated foreign reserves: The government can use its reserve of foreign currency to pay its debts.
- Selling securities: The government can pay the existing debts by selling its stock of securities such as treasury bills and securities.
- Receiving grants and gifts: The government can repay some of its debts through the grants and gifts received from donor countries.
- Privatization and profits from public enterprises: The government can privatize some of the public enterprises to get revenues to pay some debts and use profits from its enterprises to pay some of its debts.
- Barter trade: The government can influence traders to use the barter system of trade in foreign trade to reduce the use of foreign exchange.
- Negotiation on debts cancellation: The government can negotiate with donors to waive -off some debts.
- Selling of foreign investments: The government can sell some of the investments that it may own abroad.

Measures That Can Be Used to Reduce Debt Burden in Less Developed Countries

Apart from the above debt management policies, the following measures can be used to reduce the debt burden in developing nations:

(a) *Self-reliance:* LDC's can reduce dependency on foreign debts by boosting their domestic production to have a self-reliant economy, hence reduce foreign dependency.

(b) *Import control measures:* The government can apply import control measures, such as tariffs, to reduce spending on imports which is one of the reasons that increase foreign debt.

(c) *Reduction in the government's expenditures:* The government can reduce its expenditures on non-priority goods to avoid borrowing money.

(d) *Strengthening of tax collection:* The government should increase its efforts in tax collection to get enough revenues to finance its expenditures instead of depending on foreign aid.

Burden of Public Debts

The burden of public debts depends on the nature of the public debts, and whether the debt is an internal or external debt, reproductive or non reproductive debt.

(i) *Burden of internal debt:* The burden of internal debt rests on the citizens of the country because they are repayable through tax. The government is forced to increase more tax in order to collect more revenues to pay the debts.

(ii) *Burden of external debt:* The burden of external debt rests on balance of payments because they necessitate the country to pay foreign currency without return of goods and services.

(iii) *Burden of reproductive debt:* The burden of reproductive debt is not entirely on citizens because income generated by the investments in question can be used to redeem such debts.

(iv) *Burden of non-reproductive debts:* For the non-reproductive debts, the burden rests on the citizens who are forced to pay more tax in order to enable the government to get revenues to pay debts, since the money borrowed does not yield to any investment.

Why External Debt Increase?

Factors that increase external debts are as follows:

- Increase in the amount to be repaid due to the high interest rates.
- Fall in the demand for exports reduces the ability of the government to repay debts.
- Increase in the price of imports force the government to use its foreign currency on imports, instead of repaying debts
- Rescheduling of debt repayment increase the amount of debts due to cumulative interest rates.
- Wasteful expenditures on non-reproductive expenditures reduce the ability of the economy to generate revenues for repayment of debts.

Fiscal Policy

It is a macro economics policy which is used by the government to attain some economic objectives, such as control of inflation, correcting unfavourable balance of payments and achieving economic growth.

Tools of Fiscal Policy

The followings are the tools of fiscal policy.

- The government expenditures.
- Taxation.
- Transfer payments.

Mechanisms of Fiscal Policy

There are two mechanisms of fiscal policy, these are;

- Expansionary fiscal policy
- Contractionary fiscal policy
- *Expansionary Fiscal Policy:* In this policy, the government increases its expenditures and reduce the amount of tax in an attempt to increase the aggregate demand. Expansionary fiscal policy is designed to influence the aggregate demand, since when expenditures are increased on things such as education, health, road construction and salaries to civil servants; it results into an increase in income to the people. This act as a stimulant to the aggregate demand.

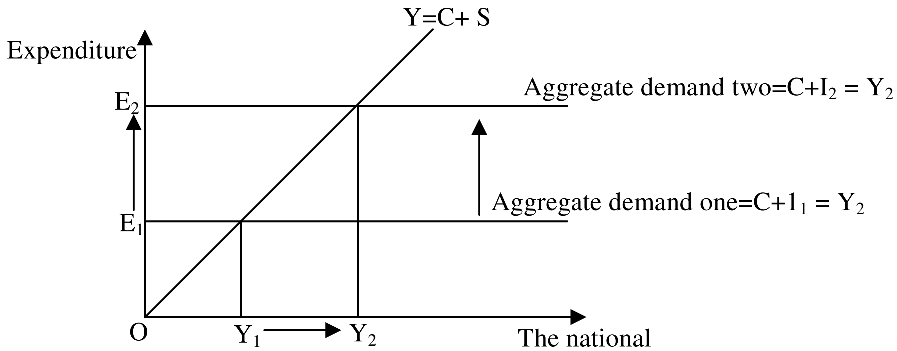


Figure 2:8: Expansionary fiscal policy

In figure 2:8 above, before the increase in expenditures, the level of aggregate demand is Y=C+I, and the national income was Y_1. After the increase in expenditures from E_1 to E_2,
Aggregate demand rose toY2= $C+I_2$, and the level of the national income increased fromY_1 to Y_2.

- *Contractionary Fiscal Policy:* This is a policy in which the government attempts to reduce aggregate demand by increasing tax and reducing expenditures. Its aim is to control inflation.

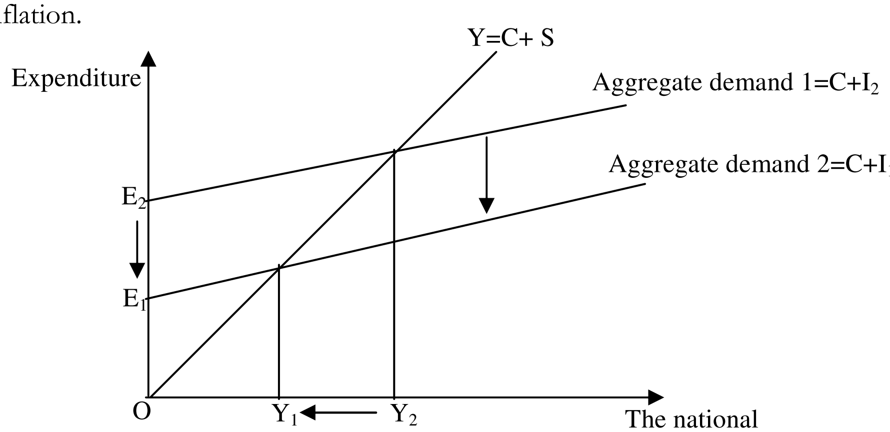


Figure 2: 9: A contraction fiscal policy

In figure 2:9 above, before the decrease in expenditures from E_2 to E_1, the National Income is Y_2, but after the decrease in expenditure, National income decrease to Y_1

Foreign Aid

Foreign aid is any form of assistance from foreign countries or foreign institutions.

Forms of Aid

(a) Technical assistance
(b) Capital (funds, machinery)
(c) Grants
(d) Gifts
(e) Consultancy

Advantages of Foreign Aid

Foreign aid can have some benefits as listed below.

(i) The recipient country may obtain technology from the donor countries.
(ii) The country can get foreign exchange.
(iii) Aid is very useful during natural calamities such as floods.
(iv) Aids promote cordial relationships between the donor country and the recipient country
(v) In the short run, aid can help to clear deficit balance of payments.

Disadvantages of Foreign Aid

Foreign aids have several disadvantages as follows:

- Aid increase the debt burden of the recipient country
- Aid cultures economic dependency
- Some aid are not provided on time therefore may not be utilized efficiently
- Some aid is accompanied by some conditions which may be harmful to the economic and social interest of the recipient country
- Some aid is of poor quality and therefore useless.
- Aid may be a disincentive for domestic production.

Review Questions

1. What is public finance?
2. Describe the types of taxes.
3. Discuss the merits and demerits of each type of tax.
4. Explain how the government may finance a deficit budget.
5. Discuss the types of budget.
6. Explain how a budget can be used as an instrument of economic policy
7. What are the uses of a surplus budget?
8. Discuss the main objectives of the government expenditures.
9. How can a national debt be redeemed?
10. Discuss the effects of deficit financing.

CHAPTER THREE

FINANCIAL INSTITUTIONS

Financial institutions are the institutions which involve themselves with financial transactions such as mobilizing of savings, provision of credits, accepting deposits, providing advice to the traders and the government.

Types of Financial Institutions

There are two types of financial institutions, namely;
(i) Banks
(ii) Non-banks

(i) Banks

These are financial institutions which perform the following functions:

- Mobilising of funds from the public and opening different types of accounts like savings accounts, fixed deposit and current accounts
- Other functions include, advancing of loans; providing various commercial services to the public, e.g. settling of debts through cheques, keeping valuable items, transferring of funds from one area to another, or from one person to another, through travellers' cheques and telegraph transfers.

(ii)Non-Banks

These are institutions which do not perform banking functions such as opening of accounts to customers or provision of commercial services, but they provide specific services to the customers or members, such as insurances and pensions. Non- banks do not mobilize savings like the banks. They obtain funds from the members through contractual savings, and these savings are normally in voluntary, they are compulsory. For example, all employees in Tanzania have a legal obligation to submit a certain amount of money each month from their salaries as contribution for their pensions to either the National Social Security Fund (NSSF) or to the Parastatal Pension Fund (PPF)

Differences between Banks and Non-Banks

Banks and non-banks differ in the following ways:

- Non-banks do not operate accounts for their customers' savings, while banks open different types of accounts such as savings, current and fixed deposits for their customers.
- Non-banks do not use savings to advance loans to the public, while Banks use savings mobilised from the customers to advance loans to immediate borrowers.
- Banks make profits through the loans advanced to their customers, while non -banks depend on revenues that they obtain through investments such as buildings, dividends on shares bought, etc.
- Banks, especially the commercial banks are established mainly to make profit, while non-banks are established mainly to provide social security to their clients.
- Mobilisation of savings by non-banks is made contractual and compulsory, while banks use persuasion to induce the public to save money.

- Commercial banks operate cheque accounts, which make them members of the Central Bank Clearing houses, whereas non-banks financial institutions are not members of the central banks clearing house, since they do not operate cheque accounts.
- Commercial banks operate bank accounts with the central bank, which is the banker's bank, whereas non-banks intermediaries do not have such a facility.
- Some deposits of customers in the commercial banks, such as in current accounts, do not get interest, whereas all deposits in the non-banks bear interest.

Types of banks

The following are the types of banks:

(a) Central Bank: This is the government's bank which is established to assist the state to control its money. It also gives financial advice to the government, and acts as a banker for the commercial banks.

(b) Commercial Banks: These offer a wide variety of banking services and are usually owned by share holders.

(c) Savings Bank: This is mainly intended to provide a safe place for keeping small deposits and pays interests on them, e.g. Post Office Savings Bank.

(d) Specialized Banks: These are banks which serve a special type of customers or aim at providing special types of services or functions to the general publics e.g. Development Banks.

(e) Co-operative Banks: These are Banks which are established to mobilize funds within a co-operative movement. The banks help co-operatives to finance for their activities.

(f) Merchant Banks: These are banks which specialize in accepting and discounting bills of exchange, and assisting traders in international trade.

Central bank

The Central Bank is the government's institution established to control, guide and assist other banks in the country, and also to provide banking services and financial advice to the government.

Bank of Tanzania (B.O.T)

Historical background

The central Bank of Tanzania (B.O.T was established by an act of parliament on 23rd December, 1965 to replace the East African currency board. The Bank of Tanzania started its functions in 1966 and issued its own currency in the same year. The central Bank of Tanzania has the following roles which can be grouped into four main functions.

(a) Banking functions
(b) Domestic monetary management functions
(c) External monetary management functions
(d) Development functions

(a) *Banking Functions*

Under banking functions, the B.O.T has the following functions:

- *Fiduciary issue/currency issue:* The Central Bank has the role of printing notes and minting coins and issuing them into the economy.

- *It is the Bankers Bank:* The Central Bank is the custodian reserve of other Banks. All banks and non-banks are supposed to keep a certain specific amount of their capital as reserves in the Central Bank, and it is the responsibility of the Central Bank to keep, the reserves safely.
- *It is the Banker of the government:* The Central Bank keeps the government's money. It is also the major advisor to formulation and implementation of monetary and fiscal policies of the country, the Central Bank can sometimes advance loans to the government in case it faces budget deficit.
- *It is a lender of last resort:* If commercial banks are short of money and cannot get them from any source, then it is the responsibility of the Central Bank to advance loans to the commercial banks
- *It is the central clearing house for commercial banks:* If any dispute concerning settlement of debts arises between two banks, then it is the responsibility of the Central Bank to settle this dispute.

(b) Domestic Monetary Management Functions

Under this function, the Central Bank has the following functions:

- Financing the government budget deficit*:* In case the government faces a budget Deficit, the Central Bank finances the deficit by providing loans to the government.
- *Management of the government debts:* The Central Bank manages the government debts both local and foreign debts, by keeping the amount and pays on behalf of the government.
- *It is a financial adviser:* The Central Bank gives advice to the government on all monetary issues, such as money supply, inflation, public debts, taxation, expenditure, etc.

(c) External Monetary Management Functions

Under this function, the Central Bank has the following functions:

- *Management of the country's foreign exchange reserves:* Under this function, the Central Bank controls all the foreign currencies which are received through exports and which are paid through imports and other payments.
- *Control exchange rate and importation of goods:* The Central Bank is responsible for determining the value of domestic currency in relation to foreign currencies. It also controls the importation of goods and services from abroad.
- *Export promotion:* The Central Bank helps in promoting the exports sector so as to increase the government's foreign exchange.
- *Participation in discussion with international financial institutions:* The Central Bank on behalf of the government, participates in discussion with International Financial Institutions and the World Bank on the stability of its currency, payments of debts and other financial assistance.

(d) Development Functions

Under this function, the Central Bank has the following functions:

- It provides medium and long-term loans to commercial banks.
- It supervises commercial banks and non-banks.
- It is involved with the formulation and implementation of monetary and fiscal policies of the country.

How the Central Bank Controls Money Supply in the country?

The Central Bank controls money supply by using the following tools instruments:

- *Open market operation:* This is buying and selling of the government securities. During inflation, the Central Bank sells securities to the public. By doing so, money is reduced/withdrawn from the public. When this happens, the prices of goods and services will fall because the public has less money to buy goods and services. During deflation, the Central Bank buys securities in order to increase money supply. An increase in money supply stimulates investment, employment and income.
- *Bank rate:* This is the rate at which the Central Bank charges to commercial banks when they borrow money from the Central Bank. During inflation, the Central Bank increases the bank rates in order to discourage commercial banks from borrowing money. In response, commercial banks increase interest rates (the rate which is charged to borrowers of money from commercial banks) in order to discourage borrowing. When this happens, the money in circulation decreases. In this case, inflation may be controlled. During deflation, the Central Banks reduces the bank rates and instructs commercial banks to reduce their interest rates.
- *Control of credits:* In order to control the money in circulation, the Central Bank instructs commercial banks to reduce the amount of credits (loans). So, in this case the amount of money in circulation decline, consequently fall in price and control of inflation. During deflation, commercial banks are encouraged to give more credits.
- *Reserves requirements:* Reserve requirement is the minimum balance which commercial banks are required to maintain as reserves, it means they are not allowed to give more than the reserve requirements. During inflation, the Central Bank instructs commercial banks to increase the reserve requirement. By doing so, the ability of commercial banks to provide credit is lowered; therefore the amount of money in circulation is reduced, leading to a fall in price and inflation. During deflation commercial banks are required to reduce reserve requirement in order to give more credits.
- *Special deposits:* These are special accounts which are opened by commercial banks at the Central Bank. During inflation, the Central Bank instructs commercial banks to make special deposits at the Central Bank apart from the usual deposits that they make. The aim is to reduce the ability of commercial banks to provide credits. In this way, the Central Bank is able to control the amount of money which commercial banks can provide as credits.
- *Special credits:* In this method the Central Bank instructs commercial banks to provide credits to special projects such as Agricultural projects and industrial projects only. The aim is to boost and control the amount of credits. During inflation, the Central Bank instructs commercial banks to provide credits to productive sectors of the economy in order to increase production.
- *Moral suasion:* In this instrument, the Central Bank persuades or advises the commercial banks to reduce the amount of credits during inflation

Contribution of Bank of Tanzania to economic development

The Central Bank of Tanzania has the following contribution on the economic development of the country.

- It provides financial facilities to the commercial banks in terms of loans, which are used by commercial banks to provide loans to investors. In this case, the Central Bank is involved with the promotion of investment in the country.

- It is involved with controlling of imports and therefore it helps to create a favourable balance of payment.
- It provides financial assistance to the government during budget deficits and, thus enables the government to meet its expected expenditures.
- The Central Bank is helpful in stabilization of the economy. In this process, the Central Bank is engaged in stabilization of the economy by controlling money supply by using monetary policy instruments. For example, open market operation, bank rates, control of credits etc.
- The Central Bank provides employment to Tanzanians. A good number of Tanzanians are employed either directly or indirectly by the Central Bank.

COMMERCIAL BANKS

These are profit making financial institutions that lend money at higher interest rates than it pays on deposits. They are formed as joint stock companies for the purpose of operating business with an aim of making profit from the services that they render to the public. Examples of commercial banks in Tanzania are; National Bank of Commerce (NBC), CRDB, Barclays Bank, Standard Chartered Bank and Stanbic Bank

Functions of Commercial Banks

- They accept money and deposits from customers
- They safe guard money, deposits and valuable documents kept with them.
- They advance loans and overdrafts for their customers.
- They provide cheque facilities which make payments easy, i.e. travelers' cheques.
- Provide night strong room safes in which money can be deposited after working hours.
- Provide employment opportunities to the general public.
- Offer trustee services to their customers.
- They pay customer's money on demand through different accounts offered, i.e. Saving, Current and Fixed deposit accounts.
- Commercial banks also create credits through the excess funds kept with them.
- They assist the Central Bank to implement monetary policies and also in replacing old currency.
- They act as clearing houses when they accept cheques from its customers which are not drawn on them but on other banks.
- They facilitate international trade by discounting bills of exchange and money transfer services on behalf of their customers. They also issue bank drafts, traveling cheques and letters of credits.
- They give financial advice to their customers.

Problems facing commercial banks in East Africa

The existence of large subsistence sectors in which most people are illiterate and production is basically for subsistence.

- There is low savings from the people, which is as a result of low income levels due to poverty.
- Some customers of commercial banks are untrustworthy and lack collateral security to secure loans.

- Most banks are concentrated in urban areas, that they are not widely spread in rural areas; hence it is a problem to mobilize savings.
- The banks have been mismanaged, through corruptions and embezzlements.
- Commercial banks charge high interest rates on loans, hence discourages many prospective borrowers.
- They lack enough skilled manpower, since there is inadequate staff training.
- They are faced with stiff competition from other commercial banks, which has led to some commercial banks being closed.
- There is the government interference in the running of commercial banks.
- There are faced with problems of poor transport and communication in rural areas.

Types of Accounts Offered by Commercial Banks

Banks provide three principal accounts, namely: ***savings accounts***, ***fixed deposit accounts*** and c***urrent accounts.***

1. The Savings Accounts

This is offered by both savings and commercial banks. It is mainly intended for small savers with low income. It encourages them to save out of the little income earned.

The Main Features/Characteristics of the Savings Accounts

- The account holder is required to deposit a minimum initial deposit.
- The account holder is also required to retain a certain minimum balance at all times.
- Deposits of any amount can be made at anytime.
- No overdrafts are allowed, but balance on the account can be used as security when applying for an overdraft.
- No cheque books are provided to the accounts holders.
- When depositing or withdrawing money, the passbook or bank card must be presented to the bank.
- The bank allows interest on deposits done in the savings account. The rate of interest is calculated as a percentage and differs from the bank to another bank.

Operating a Savings Account

In order to open a bank savings account, one has to first apply with two witnesses issued, one of whom must be a customer of the bank. To use the account, one is issued a passbook which shows deposits, withdrawals and balances. One cannot withdraw or deposit money without producing the passbook. If a customer losses it, he/she has to pay a charge to acquire a new one. In modern banking services, banks issue. Automatic Teller Machine cards (ATM) cards. These are cards that contain the data about the account of a customer: A customer can use the card to get cash from the Automatic Teller Machines (ATM) without necessarily filling in forms at the counter of the bank.

2. Fixed Deposit Account

This is an account opened with a certain minimum amount of deposit which remains fixed for a specified period of time. Here, no further deposits or withdrawals are allowed before the expiry of the period.

These deposits earn a higher rate of interest than the savings account. The account holder is issued with a receipt which he presents at the end of the deposit period. If the

account holder wants to withdraw his money before the end of the period, he/she can notify the banker but has to forego the interest or get lesser amount of interest.

Features of the fixed deposit account

(a) Fixed deposit accounts are opened for a specific period of time, e.g. 6 months, 1 year, etc.
(b) The deposits in fixed accounts can be used as security to apply for an overdraft.
(c) The banks pay interest on the deposits at higher rates.
(d) Deposits may be used by the commercial banks to advance loans to other people.
(e) Account holders are issued with a receipt, which they must present to withdraw their money at the expiry of the deposit period.
(f) Deposit accounts are opened with a specific amount, for a specific period, and no further deposits or withdrawals are allowed till the expiry of the period.

3. The Current Account

These accounts are offered by commercial banks only, and are basically for business people and large companies or organizations.

Characteristics of the Current Accounts

(a) A customer is required to make a minimum initial deposit at the time of opening the account.
(b) No minimum balance is required to be maintained. This means that the account holder may withdraw all his/her deposits.
(c) Money can be deposited at any time in any form.
(d) Withdrawals can be made at any time.
(e) Account holders are allowed to over draw their accounts.
(f) They issue cheque books, to the customers, which are used for withdrawing money from the bank.
(g) The Banks customers are issued with bank statements at the end of each month.
(h) No interest is paid on deposits; instead the account holder is charged a fee as bank charges.

How to open a current account?

In order to open a current account, one has to first apply. The applicant is usually required to fill in forms provided by the bank, having the following information:

(i) Specimen signature which will be used by the account holder whenever he/she withdrawals money.
(ii) Customer's Postal address for future correspondence.
(iii) Customer's occupation.
(iv) The applicant of the current account will need two witnesses who should be customers of that bank.

How to deposit money in the current account?

A person wishing to make a deposit must fill in a document called *a pay-in slip*. Some banks provide separate pay-in slips for cash and cheque deposits.

These slips must be filled in duplicate; the original is retained by the bank and the copy is stamped and signed by the receiving cashier and returned to the customer who can keep it for his record purposes. An account-holder can get bound books of pay-in slips which makes retention of copies easier for him.

How to withdraw money from the current account

A person wishing to withdraw money from his current account must write a cheque. A cheque is a written order, from the account-holder to his bank, instructing to pay a specified sum of money to the person named therein, or to the bearer.

Parties to a Cheque

There are three parties to a cheque.

(i) The Drawer: This is the person who writes out the cheque for payment, i.e. the account holder.

(ii) The Drawee: This is the bank for which the cheque is drawn. It pays money from the drawer's deposits.

(iii) The Payee: This is the person to whom the cheque is made payable. He/she is usually the creditor owed money by the drawer.

The cheque wherein the payee is named is called an *order cheque*. An order cheque is payable to the person named on its face *(the payee)* or to his/her order, that is, to anybody else whom the payee may name. If the payee wishes to transfer the right to receive money against an order cheque, he/she must *endorse* it, that is, he/she must sign his name at the back of the cheque and name the new payee. An order cheque is, however, not a safe method of payment.

How to write a cheque

As it has been shown, a cheque is of great importance when facilitating payments, thus a great care should be taken when handling it. The following items should appear when writing a cheque.

- *Date*: A cheque should bear the day, month and year of which it was written and signed for payment.
- *Payee's name*: This is the name of the person or firm to whom the bank will pay as per the order of the drawer.
- *Amount*: A cheque should clearly bear the amount of money which has to be paid to the payee named on the cheque; the amount, in words and figures must be indicated and the same.
- *Signature*: A cheque must be signed by the Drawer. The signature of which must be in the Bankers' records.

Cheques may be:
(i) Open cheques
(ii) Crossed cheques

(i) *Open cheques*

These are payable across the counter and may be made payable to anybody holding the cheque, or to a named person, or his/her order. A cheque wherein no payee is named is called a *bearer cheque,* and can be cashed by anybody who presents it across the counter. If a bearer cheque gets lost, there is a risk that any person who finds it succeed in getting the money indicated on it.

A cheque wherein a payee is named is called an *order cheque*. An order cheque is payable to the person named on its face (the *payee)* or to his/her order, that is, to anybody else who the payee may name. If the payee wishes to transfer the right to receive money against an

order cheque, he/she must *endorse* it, that is, he/she must sign his name at the back of the cheque, and name the new payee. An order cheque is not a safe method of payment.

(ii) *Crossed cheques*

A crossed cheque is a cheque that bears two parallel lines, called *crossings,* across its face. Crossings are usually drawn transversely on the upper left-hand corner of the cheque. A crossed cheque cannot be presented for payment across the counter; it must be deposited in a bank account. This enables the drawer or the bank to trace the payee. Crossings may be *general* or *special.*

Crossings

Crossings may take one of the following forms:

- Two parallel lines, with no words between them. This is referred as *general crossing.*
- Two parallel lines with words, '& *Co*. or '*account payee only*' between them. This is referred as *special crossing.* These words, however, do not have any significance.

A crossed cheque with or without the words, '& *Co.*', is different from an order cheque only in the respect that, whereas an order cheque can be cashed across the counter, such a crossed cheque must be presented through a bank account.

An example of an open cheque

An example of a closed cheque

Figure 3.1: Specimen of open and crossed cheques

Advantages of paying by cheque

Paying by cheque has the following advantages over paying in cash:

(a) It is very convenient. Writing a cheque takes less time than counting a large number of currency notes and coins. It may take only a few seconds to write 'Tshs. two million, three hundred and forty two thousand, six hundred and eighty two and Cents twenty five only, but counting coins and notes to this amount can take well over an hour.

(b) It is very safe. Whereas cash can be stolen and used readily by a thief, a cheque can be specially crossed to make it worthless to anybody other than the rightful payee.

(c) A cancelled cheque, i.e. the cheque against which payment has been made, is an evidence of payment in itself.

Dishonoring a cheque

In certain circumstances, a bank may dishonour a cheque, i.e. refuse payment for it.

Reasons for dishonoring a cheque

A cheque may be dishonoured by a bank if:

(i) The drawer does not have sufficient funds in his/her account with the bank. If a cheque is returned unpaid for this reason, it will be marked as R/D (Refer to Drawer) or Insufficient Funds.

(ii) The drawer is dead, or has become bankrupt.

(iii) The drawer has instructed the drawee bank not to honour the cheque.

(iii) The cheque has an error in it, e.g. the amount in words and the amount in figures do not correspond.

(iv) The cheque is stale. A stale cheque is a cheque presented six months after the date on the cheque.

(v) The cheque is presented before the date on it. Such a cheque is called a *post-dated cheque.*

(vi) The drawer has closed his account with the drawee bank.

(vii) The cheque is not signed by the drawer, or if the signature differs from the specimen held by the bank.

Other means of payment available at commercial banks

- *Credit transfer:* This is a means by which one or a number of accounts can be paid through a bank, the clearing banks operating a credit transfer similar to their cheque clearing system. Not only is the service open to the bank's customers but also to others on payment of a small fee. Credit transfers are payments made on instructions to a bank to customers of the same or other banks. To make use of this method of payment, the debtor must know the name of his creditor's bank. The advantage of this system lies in the saving it affects in stationery, stamp duty, and postage.

  If a business person wishes to settle a number of debts, under the cheque system, he/she would need to prepare a separate cheque for each creditor. Preparing a cheque could be a long procedure in certain offices. It involves the preparation of a number of documents (vouchers) and signatures by two or more important officers. Then each cheque must be posted separately, thereby causing the expense of a covering letter, an envelope and postage.

  Using a credit transfer, however, a business person would only need to prepare a list of the people he/she wants to be paid, specify the amount to be paid to each of them, total the amounts, and pay the total by one cheque to his/her bank, which will then see to it that each of the payees receives the amount due to him. It is usual to include, in the

list, the name of the bank and branch of each of the payees. If a payee does not have a bank account, his/her postal address may be given. Most employers prefer to use this method of payment to pay salaries to their staff members, who are encouraged to open bank accounts.

- *Standing orders:* A standing order is an instruction to a bank to pay a specified sum of money to a named person (or business) at regular and specified intervals, for a specified period or till the arrangement is cancelled. For example, a business person may instruct his bank to pay, say Tshs. 5000000 on the first of each calendar month, to his landlord. If he/she has acquired the premises on a lease for, say, a year, he/she may ask the bank to make twelve such remittances. If the premises are not held for a specified period, he/she may instruct the bank to keep on making the monthly payments till he/she cancels the arrangement in writing. It is a very useful service provided by the commercial banks to those business people who are very busy and have a large number of regular commitments to meet. Hire-purchase installments, rent, loan repayments, insurance premiums, etc., are examples of payments that can be safely entrusted to a bank to pay at regular intervals. It eliminates the possibility of skipping a payment and the consequences of not meeting a commitment on time. Banks charge a small fee for this service.
- *Bank Draft*: This is a cheque drawn on a bank. If a creditor is unwilling to accept a personal cheque in payment a bank draft can be used. A Bank draft drawn in a bank is safer than a cheque, the debtor having paid the bank for it in advance.

  If a person finds a supplier who is unwilling to accept a personal cheque, or if a remittance is to be made to a distant town urgently, he/she may approach a bank to obtain a *bank draft*. A bank draft is a cheque drawn on a bank and is more readily acceptable as the bank guarantees payment against it. A bank will issue a bank draft only after it has received money from the person requesting it.

  Bank drafts are mainly used to send money to another town. One reason for their popularity for this use is that they need not be sent for collection to the issuing bank, as is the case with cheques, which must be cleared by the drawee bank before any payment is made to the payee by the collecting bank. It thus speeds up payment. Drafts are also commonly used for settling debts due to overseas suppliers.
- *Travelers cheques:* These are the cheques issued by the banks in fixed denominations to a person who pays for them in advance. These are very useful for a business person who may have to travel to another town where they may find shops or hotels unwilling to accept personal cheques. Travelers' cheques are also available in foreign currencies.

  A person, wishing to buy travelers cheques, pays their value and a small service charge to the issuing bank. The bank then issues him with the cheque leaves and asks him to sign them in the presence of the bank officer. When presenting these cheques for payment, the holder must countersign the cheques in the presence of an officer of the paying bank. The two signatures will be compared and if found similar, payment would be made against the cheque. A person may also be called upon to prove his identity. This makes travelers cheques a very safe way of carrying money, because, in case they are stolen, the thief cannot cash them. Most banks authorize hotels and major shops to accept their traveler's cheques.
- *Credit cards:* These are mainly issued by banks, but may also be issued by other organizations such as Diner Club. They give the holder authority to buy goods, at shops designated by the issuing organizations, for amounts up to an agreed maximum. The selling shop then

presents the bill to the organization that issued the credit card and is paid promptly (less any pre-agreed commission). The issuing organization then bills the card-holder and either asks for prompt cash or installments in which case interest is charged on unpaid monthly balances.

CLEARING HOUSE

A clearing house is a place where different banks settle amounts that become payable to each other as a result of their client' transactions. To understand the working of clearing house, let us consider the following example. Let us suppose that; (1) Mr. BUKAGILE, who has an account with NBC Bank Ltd, issues a cheque worth Tshs. 4000000/= to Mr. KIIZA, who has an account with Akiba Commercial Bank; (2) Mr. NYAMBARI, who has an account with Akiba Commercial Bank issues a cheque for Tshs. 5000000/= to Mr. MSABILA who has an account with NBC Bank Ltd. A representative of NBC Ltd will come to the clearing house with the cheque for Tshs. 5000000/= that has been deposited with them by Mr. MSABILA. Similarly, a representative of AKIBA Commercial Bank will bring along the cheque worth Tshs. 4000000/= that was deposited with them by Mr. KIIZA. They will exchange the cheques and a note will be made of this fact. NBC Bank Ltd will now verify the signature on the cheque for Tshs. 4000000/=, to ensure that it is the same as the specimen held by them.

They will also check other details, such as the amount in figures and words, date etc, on the cheque, and then they will see if Mr. BUKAGILE (drawer) has enough funds in his account. If everything is in order, their representative will confirm the validity of the cheque to the AKIBA Commercial Bank's representative when they meet in the clearing house the following day. By that time, the AKIBA Commercial Bank would also have verified the cheque issued by their client, Mr. NYAMBARI, assuming they too found the cheque in order, the matter will be solved between the banks by AKIBA Commercial bank paying Tshs. 1000000/=, the difference in values of the two cheques, to the NBC BANK. This transaction can be settled by the Central Bank, which has the accounts of both the banks, having received instruction from these two banks. The Central Bank will simply transfer Tshs. 1000000/= from the account of AKIBA Commercial Bank to NBC Bank.

Examples of commercial banks in Tanzania

1. National Bank of Commerce (NBC)

This was established in 1967, following the nationalisation of private banks such as Standard Chartered Bank, Barclays Bank etc. It was in line with the Arusha declaration which emphasised on public ownership. The National Bank of Commerce was expected to provide solutions to the following short comings /problems of foreign Banks.

(a) Too much of domestic credit to foreigners
(b) There was low level of finance to the domestic sector
(c) Low level of domestic saving mobilization.
(d) Export of capital by foreign banks for investment abroad.
(e) Foreign dependence on management skills and other human resources.
(f) Lack of support to the government when it faces a budget deficit.

Functions of NBC

NBC, like any other commercial banks, performs the following functions:

(i) It provides loans to investors.
(ii) It mobilizes savings.
(iii) Transfer of funds from one area to another by using travellers' cheque, telegraphic transfer, money order etc.
(iv) It provides technical advice to the investors.
(v) It facilitates payment of debts through cheques.
(vi) Custodian of valuable items. The public can keep valuable items, such as gold, diamonds, certificates etc with NBC.

Following the policy of privatization, NBC was divided into two Banks

- National Bank of Commerce Ltd.
- National Micro Finance Bank (NMB)
  NBC 1997 Ltd provides services to big business people, while NMB provides service to low income earners or small business people.

2. The co-operative and rural development bank (CRDB)

Historical Background

CRDB was started in 1947 as African loan fund, comprising of:

(a) Local development loan fund to assist food production and;
(b) African productivity loan fund to assist European farmers.
In 1948 the land Bank of Tanganyika was established to assist European farmers and in 1961, the agricultural credit agency was formed into the national development credit Agency and was placed under the National co-operative and development Bank.
  (i) In 1971, the Tanzania rural Development bank (TRDB) was formed by an Act of parliament.
  (ii) In 1984, TRDB was replaced by the co-operative and rural Development bank (CRDB)
  (iii) In 1996, CRDB 1996 Ltd was formed by selling parts of its shares to individuals.

Functions of Co-operative and Rural Development Banks (CRDB)

CRDB performs the following functions:

- To provide medium and long term credits.
- To provide credits to co-operative unions.
- To help in selection of projects.
- To monitor projects.
- To enforce repaying back the loans.
- To provide banking services.
- To promote rural development.
- To facilitate purchase of crops in rural areas.
- To provide technical advice to its customers.

Note: In 1996, CRDB was transformed into a commercial bank and started operations, like other commercial banks and started to provide credits to other sectors.

SPECIALIZED BANKS

These are banks which are specialised in specific functions or sectors. Examples of specialized Banks are;

1. Tanzania Investment Bank (T.I.B)

This was established by the act of parliament in 1971, with an aim of ensuring that all the means of production are controlled by of the public.

Functions of Tanzania Investment Bank

Tanzania investment Bank performs the following functions:

(a) To make long and medium term finance available, for the development of manufacturing, assembling and processing industries.
(b) Large scale cooperate agriculture, ranching, forestry etc.
(c) To provide technical assistance and advice so as to promote industrial development.
(d) To administer such special funds as may arise from time to time.

2. Tanzania Housing Bank (THB)

The Tanzania Housing Bank was established in 1973 to perform the following functions:

(a) To provide credits for residential or commercial premises within Tanzania. The loans are provided to private individuals, public co-operations and groups of people.
(b) To receive deposit and to effect payment to three different accounts, namely, current accounts, fixed deposits and saving accounts.
(c) To provide banking services.
(d) To ensure that loans are repaid back.
(e) To make payment through bank orders.

Note: THB collapsed in 1994 because of non- performing loans.

Credit creation

Creation of credit means the process under which commercial banks advance loans many times greater than their excess reserves. This process results in an increase in the volume of bank deposits hence, in money supply. For example, if the legal amount available with commercial banks is 100 million, and on the basis of this amount, loans of 1000 million are issued, it is known as creation of credit.

Example

Assuming there are different banks in any country. If a loan of Tshs.100 million is issued by bank 'A', it will result in advance of loans many times greater than this amount as shown in the following example:

Table 3.1: Credit creation

BANK 'A'	BANK B	BANK C	BANK D
Excess reserve Tshs. 100 million. Which is loaned to a person who deposits in bank B	Primary deposit Tshs. 100 million	Primary deposit Tshs. 90 million	Primary deposit Tshs. 81 million
	Reserve ratio 10%	Reserve ratio 10%	Reserve ratio 10%
	Excess reserve Tshs. 90 million	Excess reserve Tshs. 81 million	Excess reserve Tshs.72.9 million

In the above example, Bank A has excess reserve of Tshs. 100 million which it advances to an individual who deposits the whole amount in Bank B, Bank B keeps10% of the amount as a reserve ratio and therefore advance a loan of Tshs. 90m to another person, this person deposits this amount to bank C which also maintain 10% of the amount as reserve. Then bank C advance the remaining Tshs. 81 million as a loan to another person who deposits this money to bank D. This process will continue until the whole amount of Tshs 100 million, which was advanced by bank 'A', disappear in the form of reserves ratios kept by different commercial banks. Thus, the loans advanced by different commercial banks can be expressed as under 100+90+81+72.9+…. =1000

Credit creation can be calculated by using the following formula

$$\text{Creation of credit} = \frac{\text{Excess reserve}}{\text{Reserve ratio}}$$

In this case, the excess reserve will be that loan which will be advanced as loan by Bank 'A'

In which case, the excess reserve = Tshs.100 million

Reserve ratio = 10%

$$\text{Creation of credit} = \frac{100 \text{ million}}{10\%} = \text{Tshs.1000 million}$$

Limitations on Creation of Credit

The process of credit creation is limited by the following factors:

- *Liquidity Ratio (Reserve Ratio):* This is the ratio which commercial banks keep reserve to meet the demands of the deposits. If the reserve ratio is lower then the creation of credit it will be higher, and vice - versa.
- *Power of the Borrowers:* Commercial banks advance loans to people who possess some assets which can be securities for their loans. If people who want loans have such assets, then it become easier for them to secure loans from banks, but if they do not possess such assets, it becomes difficult for them to get loans from banks.
- *Economic Depression /Stagnancy/slump:* During economic depression, the demand for credit is very low; therefore credit creation is also low.
- *Poor Saving Habits among the People:* Many people, in less developed countries, do not have the habit of saving money in banks. Therefore, banks fail to accumulate enough money that can be used to give loans.
- *Leakage of Money Out of the Banking System:* If, for some reasons, some money leaks out of the bank system, that is, money borrowed is not re-deposited in any bank, the process of credit creation will not be effective.
- *The Rate of Interest:* Interest rate is a cost of borrowing. If the rate of interest is high, borrowers are discouraged to borrow more and the process of credit creation is limited, while if the rate of interest is low, borrowers will be encouraged to borrow more money and therefore the process of credit creation will be high.

Balance between liquidity and profitability

In pursuit of profits, banks wish to hold the smallest proportion of their assets as possible, in liquid form. At the same time, financial prudence requires that they hold adequate cash and other liquid assets to meet the customers' demand for cash withdrawals; this means

that banks, as common with all other profit seeking financial institutions, are faced with conflict between liquidity and profitability.

To reconcile this conflict, commercial banks maintain an efficient portfolio of assets, starting with the most liquid assets ending with the least liquid assets, as show in figure 3:2, below. The most liquid end of the portfolio comprises non- profitable assets such as notes and coins, operational balances at the Central Bank. These are followed by short term liquid assets such as treasury bills. These liquid assets ensure a constant stream of cash to meet the customers demand for cash withdrawals. The least end of the portfolio includes high profit assets such as loans to individuals and companies. Such a portfolio may be illustrated by an inverted pyramid with the most liquid assets at the base, as shown in figure 3:2 and table 3:2 below. The assets are arranged in descending order of liquidity and ascending order of profitability.

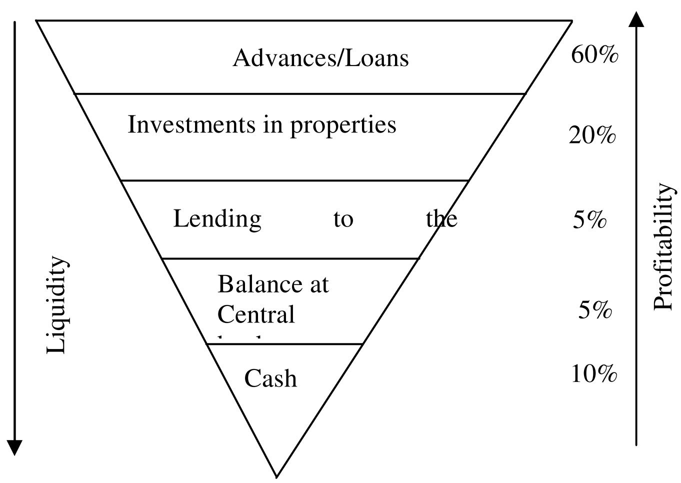


Figure 3:2: Arrangement of assets according to liquidity and profitability

In figure 3:2 above, the arrangement of assets is in descending order. The most non-liquid but most profitable assets such as loans and investments, in properties, are at the top. The most liquid and least- non profitable assets, such as cash, are at the bottom. This implies that the most liquid assets yield less or no profit and the least liquid assets, yield high profit. The arrangement of assets is further illustrated in table 3: 2.

Table 3:2 A sheet of assets of a commercial bank

S/N	Asset	Value of assets in $ million	% of total assets
1	Notes and Coins	15	15%
2	Balance at Central Bank	5	5%
3	Lending to the the government	15	15%
4	Investments	25	25%
5	Advances/Loans	40	40%
6	Total	100	100%

Table 3:2 above, shows that, the commercial bank keeps 15% of its assets in cash balance (notes and coins) and 5% as balance at the Central Bank, and the remaining 80% in profitable assets.

Problems which face banks in Tanzania

Banks in Tanzania face many problems shown below:

- Embezzlement of funds: There are some untrustworthy bank workers who steal money from the banks. This affects the financial positions of banks and hinders them from performing certain functions, such as advancing loans.
- Existence of non-performing assets: Banks have some assets which do not generate income. For example, residential houses for its workers, cars and securities which do not have dividend or returns.
- The government intervention: Before the privatization process of banks, the government was, from time to time, intervening in the activities of banks and obtain money from the banks to meet various expenditures and sometimes to meet political activities, like the elections expenditures. This affected the financial stability of banks and their ability to make decisions.
- Non performing loan: These are the loans which are advanced to individuals and firms who fail to repay back, thus cause loss to banks.
- Low saving habit of the people: Many Tanzanians, for example, do not have the habit of saving money in banks they prefer holding money in physical assets such as cattle and land, and holding cash balances instead of banking their cash reserves.
- Low level of borrowing: There is low level of borrowing among most Tanzanians due to reasons such as, lack of securities and low returns on investments.
- Low level of trained personnel and technological backwardness: Most of the banks in Tanzania do not have well trained personnel and equipment like computers. This affects the working efficiency of the banks.

Privatization of Banks in Tanzania

In 1991, the government of Tanzania passed legislation to liberalise the financial sector in the country. The aim of the new law was to stimulate financial institutions to operate commercially, following severe economic problems, which these institutions were facing. As a result of the legislation, several state owned commercial banks, such as NBC and CRDB, were privatized. Also, private companies were allowed to engage in non-banking financial services such as insurance.

The impact of the privatization of banks in Tanzania

Privatization of banks in Tanzania has the following impact:

- There is an increase in the efficiency in the operations of banking activities.
- There is injection of foreign capital.
- Advancement in technology.
- Retrenchment of workers in an attempt of these banks to increase efficiency and maintain profitability.
- Profitability has increased.
- The government's burden of giving subsidies has been reduced.
- There is minimal the government intervention

Non-banks financial institutions (financial intermediaries)

These are institutions that mobilise savings for specific objectives or purposes such as life assurance, insurance against risks, old age pensions, specific credits etc.

Non-banks mobilize savings through specific agreements/contracts with their members or credits. For example, the social security institutions, like NSSF, mobilize savings from their customers who make contributions, through deductions made on their salaries or wages.

Roles of Non-Banks Financial Intermediaries

Non banks in Tanzania play the following roles:

(i) They tend to supplement the activities of commercial banks through mobilisation of savings and easy liquidity.
(ii) They stimulate and promote financial and capital market by investing in shares and securities.
(iii) They invest in physical investments such as buildings
(iv) They too advance credits to entrepreneurs
(v) They help to increase employment to the people.
(vi) They provide social security to the people, in form of life assurance and pensions

Examples of Non-Banks Institutions in Tanzania

1. National Insurance Company (NIC)

NIC was established in 1967 after the nationalization of private owned insurance companies. The main roles of NIC are as follows:

- Collection of contributions or premium from the members or clients.
- Provision of compensation to their clients against various risks such as fire, car accidents, theft, life assurance etc. In this case, insurance helps business people to rejuvenate their business when they face any of the above mentioned risks.
- To invest in productive sectors such as buildings and in shares of various companies.
- Provision of employment to the citizens.

2. National Social Security Fund (NSSF)

NSSF, formerly NPF, was established in 1965 with the main function of mobilizing contractual savings from employees and paying them back after retirement

Roles of NSSF

NSSF has the following roles:

- Mobilisation of contractual savings from employees.
- Providing social securities to the members by paying them retirement pensions.
- Investing such funds in productive sectors such as housing, for rentals.
- Investing in shares and securities.

3. Karadha Company

This was a subsidiary of the National bank of commerce. It was established to provide financial facilities to the transport sectors by providing loans to the sector.

4. Diamond Jubilee

Its function was to provide financial assistance to builders and to build houses for renting.

5. Pride Africa or Pride Tanzania

This institution provides small scale credits to people with low incomes who do small scale business and do not possess valuable items or assets to act as securities. Pride Africa Tanzania has been very helpful in promoting the informal sectors of the economy, unlike commercial banks which provide loans to formal sectors; Pride Africa/Tanzania provides loans to their members even if they do not have any securities. The security of the loans is based on the members themselves, that is, each member in a group is a security to another member in that group. If one member fails to pay back the loan, then the other members make contributions to pay the amount due for paying the loan, because of this reason, loans provided by Pride Africa or Pride Tanzania have been attracting many people with low income.

Privatization of financial institutions in Tanzania

In 1991, the government of Tanzania passed a legislation to liberalise the financial sector in the country. The aim of the new law was to make financial institutions operate commercially following severe economic problems, which these institutions were facing. As a result of the legislation, several state owned commercial banks, such as NBC and CRDB, were privatized. Also, private companies were allowed to engage in non-banking financial services such as insurance.

The impact of the privatization of financial institutions

Privatization of financial institutions in Tanzania has the following impact:

(i) There is an increase in the efficiency in the operations of banking activities.
(ii) There is injection of foreign capital.
(iii) Advancement in technology.
(iv) Retrenchment of workers in an attempt of these institutions to increase efficiency and maintain profitability.
(v) Profitability has increased.
(vi) The government's burden of giving subsidies has been reduced.
(vii) There is minimal the government intervention.

Review Questions

1. What is a financial institution?
2. Differentiate between banking and non-banking financial institutions.
3. What is central Bank
4. Consider the roles of the commercial banks.
5. Discuss the roles of non-banks financial institutions
6. Describe the external monetary management functions of the Central Bank.
7. How do savings banks differ from commercial banks?
8. How does the Central Bank control money supply in the economy?
9. Explain the effects of privatisation of banks in Tanzania

CHAPTER FOUR

MARKETING AND DISTRIBUTION

Meaning of the Terms

1. ***Marketing***

It is the whole process of financing, storing, transporting, grading, distributing and advertising commodities to the market.

2. ***Distribution***

In this context, distribution refers to the process of transferring commodities from where they are produced to where they are needed for consumption.

Marketing and Distribution in Tanzania

In Tanzania, marketing and distribution is done by different institutions, including both private and public institutions. Examples of these institutions are co-operative societies, marketing boards, board of internal trade, board of external trade and private crop buyers.

A co-operative

Is an association of people who join voluntarily with some common economic and social interests to achieve certain objectives.

Types of Co-operatives

Co-operatives can be divided as follows:

(a) ***According to Membership Registration***

Co-operatives which fall under this category include:

(i) Primary co-operatives
(ii) Secondary co-operative societies
(iii) National co-operative societies
(iv) International co-operative societies

(b) ***According to their Services***

Co-operatives which fall under this category are:

(i) Marketing Co-operative societies
(ii) Savings and Credit Co-operative societies
(iii) Consumer Co-operative societies
(iv) Transport Co-operative societies
(v) Handcraft Co-operative societies
(vii) Multipurpose Co-operative societies
(viii) Farm production Co-operative societies

Co-operative Marketing Societies

These are the types of co-operative societies which are involved in the marketing of agricultural products.

Roles of Co-operative Marketing Societies

Co-operative marketing societies play the following roles:

- They improve the production of agricultural products by providing inputs such as fertilizers to the peasants.
- They increase the bargaining power of the peasants.
- They conduct market research for the agricultural crops.
- They market peasants' produce.
- They provide social services to members. For example, building of schools.

Problems facing co-operatives societies

Co-operative societies face the following problems:

- Inadequate and unskilled manpower
- Lack of funds to pay farmers
- Shortage of transportation facilities
- Poor quality of crops from peasants
- Unpaid debts from peasants
- Shortage of transportation facilities
- Misuse and embezzlement of funds
- Corruption
- Lack of proper management skills

Marketing Boards

The following are some of the marketing boards in Tanzania:

(i) Cotton marketing board
(ii Coffee marketing board
(iii) Cashew nut marketing board

Roles of Marketing Boards

Marketing boards play the following roles:

- *Buying Produce:* Marketing boards guarantee that all produce brought to them will be bought by the board, at an agreed price, provided it meets the specifications laid down by the board. The objective of marketing boards is not to make profit out of their activities but to help the farmers. They, therefore, offer the best possible price. The price is, in many cases, decided by the government upon advice from the marketing board concerned and represents the true value of the produce in prevailing circumstances. Except in very few cases, farmers are permitted to sell their produce directly to the processor, if they find the board's prices unacceptable.

  The marketing board buys produce through three channels. Large-scale farmers can sell directly to the board. Small-scale farmers can sell through either their respective co-operative societies or a buying agent, appointed by the board. Buying agents and co-operative societies are paid a commission for their services.
- *Collection and storage:* In most cases, the produce is collected by the board from the farm where it grows and stores it in warehouses. By so doing, it relieves the farmers of transport problems and enables the board to carry out the necessary inspection before it buys the lot.
- *Assistance to farmers:* Marketing boards offer assistance to farmers in various forms. They pay the farmers on the spot, i.e. before the produce is needed by the true

consumers. Other services offered by the boards include providing: fertilizers, pesticides, farming tools, etc. at reduced prices. They also supply best quality seeds, bags and other packing materials at low cost and also advance loans to farmers to buy agricultural equipment so as to improve their production.

- *Research:* Most marketing boards, or advisory boards where applicable, spend considerable amounts of money each year on research into agricultural and marketing problems. Large boards have their own research centres where various methods of growing crops, improving the quality of the produce, etc, are developed. Other boards contribute to the establishment or running costs of independent or the government research for the farmers by publishing booklets, brochures, etc. or by showing films through mobile film units. The board's personnel also visit farmers and offer useful advice.
- *Control of production:* As a marketing board in most cases, it is obliged to buy all that is offered to it. It is important that it takes suitable steps to avoid over-production of certain commodities to stabilize price. Marketing boards often establish quotas for various co-operative societies. Any produce brought in excess of that quota is rejected.
- *Selling produce:* Marketing boards may sell the produce to local processors or auction it for export. In the former case, the price charged by the board to the processors is determined by the government. This ensures that the consumer is not exploited. In the latter case, the board holds auctions which are attended by interested foreign buyers, in which the produce is sold to the highest bidder.

Problems facing marketing boards in Tanzania

Marketing boards in Tanzania face the following problems:

- *The government interference:* Marketing boards are not wholly independent; they are sometimes being interfered with by the government; in some decisions such as price fixing.
- *Price fluctuations in the world market:* Prices of agricultural products in the world market tend to fluctuate. This causes complaints of peasants against marketing boards.
- *Problem of overproduction of crops:* Sometimes farmers overproduce agricultural products and cause problems of marketing.
- *Untimely payment to farmers:* In most cases, marketing boards fail to pay farmers on time due to lack of funds.
- *Low demand of crops in international markets:* Crops marketed by marketing boards may have low demand in the world market due to low quality and oversupply.
- *Competition from private buyers:* Following the privatisation of marketing of crops in the country, marketing boards are faced with a stiff competition from private buyers who are sometimes more efficient and offer better prices.

Board of Internal Trade (BIT)

The board of internal trade was established by the act of parliament in 1973 to replace the state trading company. Some of the companies which are under the board of internal trade are:

(i) National pharmaceutical company
(ii) Regional trading companies
(iii) Agricultural and industrial company
(iv) Biashara and trading company

(v) Household company
(vi) Biashara consumer's services
(vii) Dar es Salaam textile company
(viii) Building hardware and electrical company
(ix) General food company

Note: Most of these companies have been privatised.

Functions of the Board of Internal Trade

The board of internal trade performs the following functions:

- Setting and revising internal trade policies.
- Conducting market research.
- Supervising and coordinating internal trade activities.
- Supervising, designing the accounting and operating systems.
- Staff recruitment.
- Providing consultancy to the companies under it.

Board of External Trade (BET)

It is a board established to promote external trade

Roles of the Board of External Trade

The board of external trade performs the following functions:

(i) Conducting market research.
(ii) Providing trade information to exporters.
(iii) Training of personnel in foreign trade.
(iv) Consultancy service in product adaptation, packaging, costing and pricing.
(v) Formulation of export strategies.
(vi) Providing export publicity.
(vii) Participating in trade fairs outside the country.
(viii) Organising of trade fairs in the country.

Private Crop Buyers

After adopting trade liberalization policy, private crop buyers have been allowed to purchase cash crops directly from the peasants, and several companies have been registered to engage in buying and selling cash crops. These companies buy crops directly from the farmers.

Advantages of Private Crop Buyers

Advantages of private crop buyers are as follows:

(i) It has increased competition in the buying of crops which, in some cases, has led to increase in the prices of the crops.
(ii) It has reduced bureaucracy in buying crops, because private crop buyers buy directly from the peasants and therefore increase efficiency in buying the crops.
(iii) It has reduced the debt burden that peasants were shouldering through co-operatives.
(iv) Most of the private buyers provide incentives to peasants
(v) Private crop buyers have been buying crops on cash basis, unlike co-operatives which used to purchase on credit.

(vi) It has reduced the burden of the government of providing subsidies to the co-operatives.
(vii) Delay in purchasing and payment to peasants has been reduced, peasants sell their crops on time and payments are usually done on the spot.

Disadvantages of Private Crop Buyers
Private crop buyers have the following demerits:
- Weak supporting infrastructure needed for marketing crops, such as vehicles and stores, in rural areas.
- Poor support to peasants. Most of the private crop buyers do not provide inputs to the peasants as co-operatives used to do.
- In some areas, private buyers have been forming joint ventures in order to control the prices and therefore buy crops at low prices.
- Competition in buying crops has, in some cases, led to the drop in the quality of the crops, since, in some instances; peasants are enticed to sell crops prematurely in order to make quick money.
- The bargaining power of the peasant is weakened because the peasant cannot influence the price of the commodities alone.
- In some areas, the existence of private buyers has reduced the strength of co-operative societies.
- Private crop buying has created a big excitement of making quick money among the residents of rural areas; this has led to an increase in theft of crops in some areas.
- Private crop buyers sometimes lead to instability of income among the peasants when they purchase crops even in small amounts, which earn peasants little money.
- Since private crop buying was permitted it has been observed that companies have been making little efforts to develop production of crops.

Transport and communication

Meaning of Transportation
Transport is the physical transfer of both goods and services or people from one place to another place.

Elements of Transport
There are four elements of transport:
(a) *The way:* Goods must move on something such as water, land or air. This is called the way. Ways may be natural like the sea, the air or lakes; or man-made like roads, railway tracks or bridges. Natural ways are free; they cost nothing to acquire or maintain but are not always available. For example, Uganda has no sea touching her borders. Man-made or artificial ways cost large sums of money to construct and to maintain. But, in most cases, these costs are borne by the government which of course gets money by imposing taxes on the citizens. Thus, these costs are paid by the people indirectly.
(b) *Unit of carriage:* These are the vehicles which carry goods or passengers; they may be trucks, lorries, trains, ships or aeroplanes. These are referred to as units of carriage.
(c) *Method of propulsion:* A unit of carriage must be driven by some forces or power. Common methods of propulsion are the petrol engine, jet engine and electric motor. The choice of the method depends on the size of the vehicle, speed desired and the fuel available.

(d) *Terminals:* Goods must be loaded and off-loaded somewhere. These places are called terminals. Often, a terminal of one unit of carriage is the starting point of another vehicle. For example, a railway station marks the end of the journey of goods by train.

Types/forms of Transport
There are three main forms of transport - land, water and air.

Land Transport
This includes the following forms: *human portage, animal transport, road transport, railways transport* and *pipeline.*

1. *Human Portage*
This is the most common type of transport used by the majority of the people in various parts of the world. This is because most parts of the world are remote; severely lack capital and skills to put in place the modern methods of transport. A person who carries things is called *a porter*.

Advantages of Human Portage
Human portage has the following advantages:
- It can be used where other forms of modern transport cannot be used. For instance, in the mountainous or swampy areas.
- It is readily available on demand.
- The cost of hire is low.

Disadvantages of Human Portage
Human portage has the following advantages:
- It is slow
- Laborious to the users.
- It is limited to some types of goods and cannot transport large cargo.

2. *Animal Transport*
This is the form of transport which involves the use of animals. It is not so well developed in many parts of the world. It is commonly used in those areas which are wild and hostile such that other means of transport are hard or difficult to use. The animals that are commonly used may include camels, donkeys, horses, cattle, dogs etc. Animals can be used for riding, as well as carrying or pulling loads.

Advantages of Animal Transport
Animal transport has the following advantages:
- Animals are quicker than human beings.
- They carry heavier and larger loads than human beings.
- Animals are capable of being used in adverse (hard or hostile) conditions like deserts and waterlogged regions.
- It is relatively cheap and more developed than human portage.

Disadvantages of Animal Transport
Animal transport has the following disadvantages:
- Cannot transport bulky cargo
- Cannot transport over long distances

- It is slower than vehicles.

3. *Road Transport*

Road transport involves the use of vehicles, bicycles and motorcycles. In Tanzania and East Africa at large, road transport is the most important and it will continue to play a vital role in the economic development of the East African countries.

Advantages of Road Transport

Road transport has the following advantages:

- Road transport is flexible. It can be constructed in many places and can serve even individual homesteads.
- Road transport offers a variety of transport facilities; giving transporter a wider choice of the type of facilities to use. For example, the facilities can be trucks, taxis, buses etc.
- It is faster and cheaper at shorter distances.
- It is suitable for delivering perishable goods, e.g. vegetables, milk, fruits and so on for short distances.
- Road are easy to construct and run compared to railway or air transport.
- Vehicles that move on the roads do not need to run on time schedule like trains and planes. However, schedule may be involved at a minimal extent with buses.

Disadvantages (Short Comings) of Road Transport

Road transport has the following disadvantages:

- It handles a specific and limited amount of goods.
- Usually, heavy loaded lorries are too slow to cover up the expected distance in time.
- It is too risky, especially for delicate goods. It can cause breakage or destruction of goods like computers and glass materials, hence causing a great loss.
- Weather conditions tend to disrupt road transport, especially during the rainy season. It is highly susceptible to attacks by highway robbers on the way.
- Road transport has led to an increase of road accidents, leading to the loss of lives of many people
- When there is congestion (traffic jam), road transport causes delays to users.
- Transport facilities have contributed to air and water pollution in the world.
- Construction of roads encourages land degradation.

4. *Railways Transport*

This involves the carrying of goods and passengers by train. Today, railways transport has become an important means of transporting bulky goods. This has been a result of the rapid industrial development in various parts of the world, where bulky raw materials and finished products have to be transported for long distances to their destinations.

Advantages of Railways Transport

Railway transport has the following advantages:

- It is suitable and relatively cheap for transporting bulky commodities or goods over long distances
- It is less affected by unpredictable weather conditions, if well constructed

- Once the railway has been constructed, its maintenance costs are relatively low and hence freight charges are usually lower, over long distances, than those charged by the roads, for most commodities.
- More loads and a great number of people may be transported at a single journey compared to road and air transport systems.

Disadvantages of Railways Transport

Railway transport has the following disadvantages:

- The railways are expensive to build. A lot of money is required to lay down the lines and all other facilities such as stations, warehouses etc.
- It is not flexible like road transport. Only areas with railway lines can be served. Also, door-to door service cannot be undertaken and it is also not good for perishable goods like milk and vegetables, or goods which are urgently needed like medicine, daily newspapers etc.
- Railways transport is mostly inefficient and time conserving especially in the developing world, where train services are too slow and backward. Because it strictly adheres to time schedule, sometimes it may cause some inconveniences and delays. Rail transport is a bit costly in terms of equipment, rail setting and purchasing the train and maintenance. The gauges of the railway lines vary from one place to another. In some places, the gauges range from 1.5 - 1.7 metres while others have gauges that are as narrow as 1 metre. Many parts of Africa have narrow gauges.

5. *Pipelines*

These are types of pipes constructed to transport liquid materials such as oil. An example of a pipeline is the TAZAMA pipeline, which is jointly owned by TANZANIA and ZAMBIA, and it transports oil from Dar es Salaam to Ndola, in Zambia.

Advantages of Pipelines

Pipelines have the following advantages:

- They are economical since it involves low cost of operation and maintenance.
- They are not affected by unfavourable weather conditions.
- They can cover long distances.
- They can carry large volume of goods.
- They are very reliable.

Disadvantages of Pipelines

Pipelines have the following disadvantages:

- The risks of destruction are very high.
- In case of accidents, enormous damage can occur.
- They cannot be effective in mountainous areas.
- In case of leakage, they can cause environment hazards.
- They cannot carry solid goods.
- Initial costs of construction are very high.

Water Transport

This is the type of transport by using water; it is divided into two main groups, namely;

(i) *Inland water transport:* This includes transport by rivers, lakes and canals.
(ii) *Ocean water transport:* This includes transport by using oceans.

Advantages of Water Transport
Water transport has the following advantages:
- It is cheaper than other means of transport since there are no costs which are involved in constructing water ways, as it is for roads and railways.
- It transports heavy and bulky loads over long distances.
- It is suitable for transporting fragile goods.
- The risks of accidents are less than other means of transports.
- It is economical for transporting large quantity goods than other means of transport.

Disadvantages of Water Transport
Water transport has the following disadvantages:
- It is inflexible, since it cannot be used in areas where there are no water bodies.
- It is uneconomical when the quantity of goods is small.
- Delay in delivery due to the slow speed of the ships.
- It is unsuitable for carrying passengers over long distances.
- The amount of loss, in case of accidents is greater than other means of transports.

Air Transport
It is a transport by using Aeroplanes.

Advantages of Air Transport
Air transport has the following advantages:
- It is the fastest means of transport.
- Risks of damage are low.
- It is free from physical barriers, such as mountains and oceans.
- It is comfortable and less tiresome.
- It can be used over very long distances.

Disadvantages of Air Transport
Air transport has the following disadvantages:
- It is limited on the quantity of goods.
- It is less reliable during bad weather conditions.
- It is inflexible, since it cannot be used where there are no airports.
- It is the most expensive means of transport.
- The costs of buying and maintenance of aeroplanes is very high.
- In case of accidents, the effects are always fatal.

Factors for choosing Mode of Transport
The following factors are considered before choosing the mode of transport to use.
- The nature of goods to be transported whether fragile, perishable or durable
- The weight of the goods
- The bulkiness of the goods
- The cost of transportation
- The speed and urgency
- The distance.
- The available transport links
- The means available

Communication

Communication is the transmission of information from one point or person to another point or person. Transport and communication are related since, through transport, information can move from one place or person to another.

Means of Communication

There are various types or means of communication.

(a) *Oral communication:* This involves communication through the following means, such as the telephone, radio, gestures etc.

(b) *Written communication:* This involves communication by using the following means, such as letters, parcels, postcards, telegrams, e-mails etc.

(c) *Visual communication:* This includes means such as charts, photographs, films etc.

Roles of Transport and Communication in the Economy

Transport and communication play the following roles:

(i) They create market for goods and services
(ii) They make mass production possible by ensuring market for the goods produced.
(iii) They make goods available where they are needed for consumption
(iv) They bridge the gap between producers and consumers
(v) They make easy transaction between producers, sellers and consumers.
(vi) They increase the mobility of labour.
(vii) They create employment to the people.
(viii) It enables producers to have access to inputs, such as raw -materials, from different areas.
(ix) Transport and communication enhances the attainment of place utility.
(x) Technology can easily be transferred from one area to another through transport and communication.
(xi) Trade information is possible through communication; therefore, communication leads to an increase in the volume of trade.
(xii) Transport and communication facilitates the development of other economic sectors, such as industries and agriculture.

Problems Facing Transport and Communication in Tanzania

Transport and communication face the following problems:

- Frequent accidents.
- Poor roads which are impassable.
- Shortage of capital to purchase and operate vehicles.
- Unskilled personnel.
- High running costs such as hiked price of oil and spare parts.
- Large initial capital outlays
- Small quantity of goods to transport makes some means of transport, such as air and railways, uneconomical.
- The remoteness of some regions makes it difficult to have access to such areas.
- Bad weather conditions destroy the means of transport and affect travelling.

Review Questions

1. What is marketing and distribution?
2. Discuss the roles of co-operatives in marketing and distribution.
3. Explain the roles of marketing boards.
4. Discuss the merits and demerits of private crop buying and selling.
5. Describe the roles of the Board of External Trade.
6. "The Board of Internal Trade is irrelevant to the current economic situation in Tanzania.
7. Differentiate between transport and communication.
8. Examine the problems which affect transport and communication in Tanzania" Discuss.
9. Discuss the roles of transport and communication in the economy.
10. Explain the advantages and disadvantages of air transport

CHAPTER FIVE

INTERNATIONAL TRADE

International trade is a trade among nations. It involves selling and buying goods and services to and from abroad respectively. Selling abroad is known as *exporting,* and buying from abroad is known as *importing*.

Reasons for Foreign Trade

Trade among nations exists due to the following reasons:

(a) *Differences in Natural Resources*

Some countries may have certain natural resources such as minerals and fertile soil, while other countries have different natural resources such as oil reserves. Therefore, there is a need to exchange the goods which are produced by these natural resources. For example, the Arabic countries have natural oil reserves while the African countries have fertile soil. Therefore, African countries produce and export agricultural products to the Arabic countries; in return, the Arabic countries produce and export oil to most of the African countries.

(b) *Gain from Trade*

Another reason for the existence of international trade is gain from trade. Countries earn revenues and profit by engaging in international trade.

(c) *Differences in Human Skills*

Citizens of different countries have different skills. These differences in the skills result in differences in the types of commodities which are produced, thus necessitate the need for exchange of commodities among countries. For example, Tanzania has people who are very skilful in making carvings, while America, Japan and European countries have people with skills in industrial manufacturing. Therefore, Tanzania is able to produce and export carvings to these countries, and in turn import manufactured goods from the same countries.

(d) *Uneven distribution of capital and technology*

Capital and technology are unevenly distributed among countries. Therefore, the countries without enough capital and technology are forced to import goods from the countries with the capital and the technical capacity of producing goods. For example, most African countries are faced with the problem of lacking the capital and technology to produce goods, there is hence a need to engage in international trade so as to export the raw materials and import the manufactured goods such as cloth, cars, electronic equipment, etc.

Theories of absolute advantage and comparative cost

Principle of Absolute Advantage

This principle was advanced by Adam Smith. It states that, "If a nation is more efficient than another nation in the production of a certain commodity, i.e. uses fewer resources, but is less efficient than another nation in the production of a commodity, then both

nations can gain by each nation specializing in the production of a commodity of its absolute advantage".

Specialization results in the following:
(i) Full utilization of resources in both nations
(ii) Increase in output in both nations
(iii) Both countries will gain from exchange

Assumptions of the principle of Absolute Advantage
The principle of absolute advantage has the following assumptions:
- Assumes two nations and two commodities
- There is free trade
- There is no transport cost
- Factors of production are perfectly mobile
- No technological differences between the two countries
- Labour is homogeneous in both the two countries
- Labour theory of value, i.e. the value of a commodity is exclusively determined by the amount of labour expended during in the production of the commodity.
- Perfect competition situation

Table 5.1: Example of absolute advantage

Country	**Cost (labour) of producing one unit of output**	
	Commodity	
	Cars	Sisal
Tanzania	30 (Labour units)	10 (Labour units)
USA	10 (Labour units)	20 (Labour units)

In table 5:1 above, USA has an absolute advantage in the production of cars, because it uses few resources in its production, but absolute disadvantage in the production of sisal because it uses more resources in its production. On the other hand, Tanzania has an absolute advantage in the production of sisal, because it uses fewer resources in its production and an absolute disadvantage in the production of cars because it uses more resources in its production.

Reasons
- 10 units of labour, in the USA, can produce one unit of cars, but 20 units of labour to produce one unit of sisal.
- 10 units of labour, in Tanzania, can produce one unit of sisal, but 30 units of labour are needed to produce one unit of cars.

According to the absolute advantage theory, both nations will gain if:
- USA specializes in the production of cars
- Tanzania specializes in the production of sisal

Comparative Advantage Principle or the Principle of Comparative Cost
This principle was advanced by *David Ricardo.*
"It states that even if one nation is less efficient in the production of both commodities, i.e. uses more resources to produce, and another nation is more efficient in the production of both commodities, i.e. uses less resources, still there is basis for mutual beneficial trade between the two nations. Each nation will benefit by specializing in the production and

export of the commodity which the relative cost and opportunity cost of producing is lower, and imports the commodity which the relative cost and opportunity cost of producing is higher".

Table 5.2: An example of comparative advantage

Country	Units of labour required to produce	
	1 barrel of maize	I bolt of cloth
Kenya	90	60
Tanzania	30	30

In table 5:2 above, Tanzania has absolute advantage in the production of both commodities, since; it takes fewer units of labour to produce both products than does Kenya, but by looking into internal cost ratios of each country, and Tanzania has absolute advantage in both the production of maize and cloth. However, her absolute advantage is greater in maize production than cloth (90/30 > 60/30). She can out-produce Kenya by 3:1 in maize and only 2:1 in cloth. A greater absolute advantage, such as Tanzania has in maize, is called comparative advantage. Kenya is at absolute disadvantage in both maize and cloth, but it is at a lesser absolute disadvantage in cloth (60/30 < 90/30), in which Tanzanians out produce it only by 2:1. A lesser absolute disadvantage is also called a comparative advantage. Thus, Kenya has a comparative advantage in cloth production and can gain from trading its cloth for Tanzania's maize.

Criticisms against the Principle of Comparative Advantage and Absolute Advantage

- They assume that there are two nations and two commodities. This assumption is unrealistic because nations produce more than one Commodity
- Transport costs are involved in international trade.
- The labour theory of value is invalid.
- Labour is not the only factor of production.
- Labour is not homogeneous.
- The distribution of gains is not even as explained by theory.

Application of the Principle of Comparative Advantage

The principle of comparative advantage has the following applications:

- It provides the basis of trade between nations and sets the rates of exchange between the two commodities.
- It leads to balance of payments between the two trading nations.
- It enhances specialization of production between two nations.
- It encourages free trade.

Terms in International Trade

Visible Trade

This is the trade on physical goods that can be touched and seen such as television, radio, cloth, food etc.

Invisible Trade

This is a trade on invisible items like services, technology, consultancy, banking, insurance, health, education, transport etc.

Balance of Trade

This is the difference between the value of export goods (visible exports) and the value of import goods (visible imports).

Balance of trade = Total value of exports - Total value of imports

Balance of trade can be favourable, unfavourable or balanced.

(a) *Favourable Balance of Trade*

Balance of trade is said to be favourable when the value of exports of visible trade is greater than the value of imports of visible trade.

Favourable balance of trade: Exports (visible) >Import (visible)

(b) *Unfavourable Balance of Trade*

Balance of trade is said to be unfavourable when the value of visible imports is greater than the value of visible exports.

(c) *Balanced Balance of Trade*

Balance of trade is said to be balanced when the value of visible exports of a country is equal to the value of visible imports.

Balance of Payments

This is the difference between the receipts (earnings) of a country from abroad and the payments of a country to abroad. It can also be defined as the systematic record of a country's transactions with the rest of the world.

Balance of payments can be *favourable, unfavourable* or *balanced.*

(i) *Favourable balance of payments:* Balance of payments is said to favourable when the country's receipts from abroad are greater than the country's payments to abroad.
(ii) *Unfavourable balance of payments:* Balance of payments is said to be unfavourable when the country's payments to abroad are greater than the country's receipts from abroad.
(iii) *Balanced balance of payments:* Balance of payments is said to be balanced when the country's receipts from abroad are equal to the country's payments to abroad.

Major Accounts in the Balance of Payments

Balance of payments has the following major accounts:

- *Goods and services accounts:* This deals with the systematic record of payments to foreigners in a specific period of time.
- *Unilateral transfers:* This records things such as grants and gifts
- *Long term capital account:* This records inward and outward flow of capital.
- *Short term capital:* This deals with the financial flows to finance trade, exchange rates and interest rates.
- *Unrecorded transactions:* This deals with recording of omitted transactions, i.e. transactions which have not been captured in other accounts.
- *Official reserves transaction balance accounts:* This deals with the final balance, it may be positive or negative.

These accounts can be divided into the following two main accounts:

(i) Current account
(ii) Capital account

(i) Current account

This records the country's visible and invisible exports, on one side, and visible and invisible imports, on the other side.

(ii) Capital account

This deals with the record of inflow and outflow of capital from abroad in form of loans or grants.

Table 5.3: A Hypothetical Example of a Balance of Payment Account

Receipts in Tshs. (Millions)		**Payments in Tshs. (Millions)**	
Items	Amount	Items	Amount
1.Visible exports	2	1.Visible imports	5
2.Invisible exports	1	2.Invisible imports	2
3.Loans	3	3.Repayment of loans	6
4.Grants	1	4.Expenditures by Embassies	2
5.Gifts	1	5.Payments to foreigners	1
Balancing item	8		
	16		16

Disequilibrium in the Balance of Payments (Deficit in the Balance of Payments)

The balance of payments is said to be in disequilibrium when the total payments to abroad is greater than the total receipts from abroad.

Causes of Disequilibrium in the Balance of Payments

Disequilibrium in the balance of payment is a result of the following factors:

- *Low exports:* Disequilibrium in the balance of payments can result due to low demand elasticity for a country's exports, and decline in the supply of goods for exports.
- *Increase in the demand for imports:* The demand for imports can increase due to low production of essential goods in the domestic economy.
- *Unfavourable terms of trade:* When the price of exports fall while that of imports rise, it leads to a decline in the amount of receipts from abroad and an increase in the amount of payments to abroad.
- *Shortage of capital goods:* Less developed countries are faced with the problem shortage of capital goods. They are forced to import this capital from abroad. This causes disequilibrium in the balance of payments.
- *Devaluation policy:* Sometimes devaluation policy, which is adopted by a country, may result in the deficit in the balance of payments. This occurs when the country's exports have low price elasticity, and when the imports have inelastic demand or when other countries which export similar products also devalue their currencies.
- *Unfavourable climatic condition:* Unfavourable weather conditions lead to a fall in agricultural production and consequently in the country's exports, hence deficit in the balance of payments.

Correction of the Deficit in the Balance of Payments

The following methods of correcting the deficit balance of payments may be adopted:

- *Promotion of exports:* The government can promote exports by providing subsidies to exporters, tax exemptions and trade fairs.
- *Reducing expenditures on imports:* The government can discourage imports by imposing high import tariffs.

- *Devaluation policy:* A country can reduce the value of its currency in order to promote exports and discourage imports. When the currency is devalued, exports become cheaper while imports become more expensive.
- *Increase production:* Another method of correcting a deficit is to increase the production of both export and import goods.
- *International co-operation:* There are efforts which are internationally made by institutions, such as International Monetary Fund, the World Bank and World Trade Organization, to correct disequilibrium in the balance of payments.
- *Financial assistance from donor countries:* A country can improve its balance of payments position by getting financial assistance from abroad donor countries.

Effects of a Persistent Deficit in the Balance of Payments

A deficit in the balance of payments has the following effects:

(i) A persistent deficit may imply a fundamental lack of competitiveness and failure in the country's export trade. Poor export performance could be attributed to international competition, inappropriate commodities, technological retardation or an over-valued currency. These factors call for the government's action.

(ii) A persistent current account deficit usually implies an increasing reliance on imports by both the producers and the consumers in a given country. This may hinder the development of domestic industries, which would have probably had the capacity to produce some of the inputs being imported. The level of imports increases as income rises because of the import dependency that has developed.

(iii) In the case of a persistent deficit, a financing problem may eventually arise as foreign currency reserves are depleted, and loan arrangements with foreign the governments and other lending institutions become increasingly difficult to obtain.

(iv) A persistent current account deficit may also lead to a need to invoke domestic policy constraints, such as deflationary measures, devaluation or import controls, which may have adverse side effects.

A persistent current account surplus usually indicates fundamental competitiveness of a country's exports, and hence, to some extent, its success as a trading nation. The firms in the country with a surplus in the balance of payments have products whose prices and quality are competitive.

The existence of current account surplus is likely to strengthen the domestic currency of the country with the surplus, and hence cheaper imports which may have a positive impact on the standard of living. However, persistent surpluses may also be problematic in the following ways:

- Such surpluses imply that the trading partners will be in deficit and may have the associated difficulties of financing their deficits. As a result, such deficit trading partner may impose import restrictions such as tariffs or quotas.
- Trade surpluses also create additional income in the economy which could contribute to inflationary pressures through an increase in the money supply.
- Persistent surpluses also contribute to an appreciation of the exchange rate of the country experiencing the surplus, thereby making exports relatively expensive and imports relatively cheaper. In the long term, the surplus could thus adversely affect the international competitiveness of the country experiencing the surplus.

Terms of trade

Terms of trade is the ratio between the price index of exports and the price index of imports. It is expressed as follows:

$$\text{Terms of trade} = \frac{\text{price index of export}}{\text{price index of import}} \times 100$$

Measurement of Terms of Trade

In its simplest and most direct form, terms of trade index is the ratio of the price index of export to the price index of imports. For any country, export price index can be calculated by selecting a representative group of export goods, and determining the weighted average of their prices. A base year is also selected, and usually the index number of the base year is 100. For the following years, the weighted average price for the same group of export goods is calculated, and the index number for each year is expressed as a percentage of the original year's number (100).

Thus, if 2003, is the base year (index = 100) and in 2004, the weighted average price of the export goods is 50% higher than the 2003 price, the index for 2004, will be 150.

A country's import price index can be calculated by using representative import goods rather than export goods as the relevant data. Its terms of trade index is simply its export price index divided by its import price index and multiplied by 100, or

$$\text{Terms of trade} = \frac{Px}{Pm} \times 100$$

Example

Suppose that, from 1985 to 1999, the export price index of Tanzania rose from 100 to 140 and the import price index rose from 100 to 160. Tanzania's terms of trade obviously worsened, because the weighted average price of its exports increased by less than the weighted average price of its imports. This is reflected as a decline in its terms of trade index. Using the formula just given, we have

$$TOT1 = \frac{100}{100} \times 100 = 100,$$

$$\text{And} \quad TOT2 = \frac{140}{160} \times 100 = 87.5$$

Where TOT1 is the terms of trade for Tanzania in 1985 and TOT2 is the terms of trade in 1999.The index shows that a given amount of Tanzania exports would buy only 87.5 as much in imports, in 1999, as it would in 1985. Alternatively, we can say that, in 1999, Tanzania had to export a larger physical output of her goods to buy the same amount of foreign goods that they imported in 1985.

Different Ways of Measuring Terms of Trade

The following are some of the ways of measuring terms of trade:

(i) *Net Barter or Commodity Terms of Trade*

This is the ratio between the price index of exports and the price index of imports.

$$\text{Terms of trade Net barter} = \frac{\text{price index of export}}{\text{price index of imports}} \times 100$$

(ii) *Income Terms of Trade or Capacity to Import*

This is the ratio between the product of the price index of export and the quantity of export to the price index of imports times 100

$$\text{Terms of trade Capacity to import} = \frac{PxQx}{Pm} \times 100$$

Where;

$$Qx = \frac{Vx}{Px}$$

Px = Export price index
Pm = Import price index
Qx = Quantity of exports
Vx = Volume of exports

(iii) *Gross Barter Terms of Trade*

This is the ratio of the quantity index of exports to quantity index of imports times 100.

$$\text{Gross barter terms of trade} = \frac{Qx}{Qm} X100$$

Where;
Qm = Quantity of imports
Qx = Quantity of exports

Determinants of Terms of Trade

Terms of trade can be affected by the following factors:

(a) *Tariffs on imports:* When the importing country imposes tariffs on its imports, it causes an increase in the price of the imports, and thus leads to fall in demand and price of these imports.

(b) *Import Quota:* When a country imposes quantitative restrictions on another country's exports, it causes fall in the price of exports of the exporting country.

(c) *Subsidization of exports:* When one country gives subsidies to producers of its exports, it may cause fall in demand and decline in demand for other countries' exports.

(d) *Degree of monopolization in the world market:* When producers of a certain commodity in the world market form cartels, such as OPEC, they use such cartels to control the supply and the price of the commodity. This leads to deterioration in the terms of trade of countries which import the commodity.

(e) *Market forces:* This is the most important factor for determining the terms of trade of a country. If the demand for a country's exports increase while the demand for imports decline, the country may experience a favourable terms of trade, but if the demand for a country's exports decline while the demand for imports increase, the country will experience deteriorating terms of trade.

(f) *Exchange rate policy of a country:* Exchange rate policy of a country, such as devaluation, can affect the terms of trade. For example, if the government devalues its currency, the price of exports falls while those of imports increase. This leads to unfavourable terms of trade.

(g) *Market situation:* This can affect the terms of trade, if a commodity is traded in a market situation in which a country is the price taker, therefore, the terms of trade for the country will be unfavourable.

Reasons for Deteriorating Terms of Trade in Less Developed Countries

Terms of trade in less developed countries deteriorate due to the following reasons:

(i) *Low price elasticity of the less developed countries' products:* Less developed countries produce primary products which have low price elasticity, while developed countries produce manufactured goods which have high price elasticity.

(ii) *Discovery of synthetic materials in developed countries:* In developed countries, manufacturers have discovered artificial or man-made materials, such as nylon and plastic, to substitute with raw-materials such as sisal and cotton. These discoveries contribute to the fall in the demand and price of the primary products that are produced by less developed countries.

(iii) *Raw-materials saving technology:* It is the technical progress aimed at economising the use of raw-materials in each item manufactured, so as to reduce the production costs per unit. An example of such technology is the recycling of bi-products whereby waste products are converted into useful materials to produce other products. Therefore, such a technology reduces the demand for the raw-materials from less developed countries.

(iv) *Import substitution industries in developed countries:* The price and demand for commodities from less developed countries is declining due to establishments of import substitution industries in developed countries, which produce commodities that were formerly imported from less developed countries.

(v) *Diminishing returns and limited supply of land:* In less developed countries, land productivity is declining, and due to the decline in the productivity of land, these countries so as are forced to import even food products from developed countries to supplement the deficit in food production. Such increase in the demand for imports increases the prices of imports hence a deteriorating terms of trade.

(vi) *Technical progress in developed countries and low technical progress in less developed countries:* In developed countries, due to technical progress, manufacturers produce goods of high quality at low cost. In less developed countries, manufacturers produce goods at a high cost but of low quality, as a result of applying poor technology. This situation influences consumers in less developed countries to prefer imported goods than home produced goods. At the same time, locally produced goods fall short of demand in the export market due to their poor quality. A low demand leads to a fall in their price hence to unfavourable terms of trade.

(vii) *Monopoly power of primary producers, such as OPEC:* Oil exporting countries (OPEC) has a monopoly power in the supply of oil in the world market. Such monopoly power causes terms of trade in less developed countries to deteriorate, because OPEC members agree to reduce the supply of oil in order to push up prices of the commodity, and as a result, less developed countries are forced to give large part of their exports in exchange for a smaller unit of oil. Therefore, the terms of trade for less developed countries deteriorate.

Remedies for Deteriorating Terms of Trade in Less Developing Countries

In order to solve deteriorating terms of trade, less developed countries can apply the following measures:

- *Import control:* A country can control unfavourable terms of trade by discouraging imports through import control measures, such as tariffs and import quota. These control measures result in a fall in the demand for imports and increase in the demand for locally produced goods.

- *Export promotion:* A country can correct deteriorating terms of trade by promoting the exportation of goods. Promotion of exports can be done by advertising the products in the world market, reducing export tariffs and providing incentives to exporters. Such measures boost the demand for these products and thus, help to increase the price and correct the deteriorating terms of trade.
- *Economic integration:* Economic integration remove trade barriers and promote the market for the commodities of the member countries, thus enable countries to correct the deteriorating terms of trade.
- *Population control:* A country can correct deteriorating terms of trade by controlling the growth of its population. When the growth of population is controlled, a country is able to reduce its import needs on essential goods such as oil, medicine and food. The fall in the demand for imports leads to a favourable terms of trade.
- *Mechanisation:* This is the system of applying machines in the process of production. Mechanization leads to an increase in the volume of production and thus enables a country to meet the demand for its citizens, and export the surplus to other countries. Also, it leads to a fall in the demand for imports and favourable terms of trade.
- *Import substitution industries:* These are industries which produce goods that were, formerly, imported, such a measure leads to fall in the demand for imports, hence a favourable terms of trade.

Protectionism (Import Control)

Protectionism is part of trade policy aimed at controlling imports and promoting exports, as a safeguard to the economy against the adverse effects of international trade.

Forms of Protectionism

Protectionism can be in different forms as explained below:

(a) *Import tariffs:* These are taxes on goods imported. Import tariffs lead to an increase in the prices of imports in relation to the locally produced goods. The increase in the price of the imports influences the local consumers to opt for locally produced goods and thus, leads to a fall in imports.

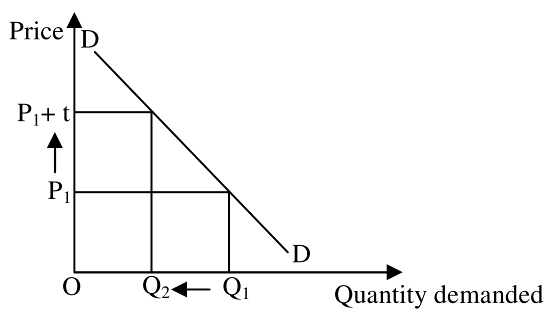


Figure 5.1: Price rise due to imposition of tariffs

In figure 5.1 above, the price and quantity demanded before imposition of tariffs is $0P_1$ and $0Q_1$, respectively. After the introduction of tariffs price increases to $P_1 + t$ (t = tariff) leading to a fall in the quantity of import demanded to $0Q_2$.

(b) *Import quota:* An import quota is the maximum amount of certain commodities to be imported at a certain period of time. Quota also discourages import.

(c) *Devaluation:* This is the reduction of the value of the domestic currency in terms of foreign currency. When the currency is devalued, exports become cheap, while imports become expensive. Therefore, devaluation discourages imports but encourages exports.

(d) *Exchange control:* In this measure, the Central Bank provides a limited amount of foreign currency to the importers in order to limit them from importing large quantities of imports.

(e) *Subsidy:* A subsidy is the government's assistance to local producers in form of funds or reduced price of inputs. Subsidies enable producers to produce goods at low costs and thus, reduce the prices of the local goods, hence encourage consumers to prefer domestic goods to imported goods, which become relatively expensive.

(f) *Total ban:* This is the policy of prohibiting the importation of certain commodities which have some negative cultural or economic impact, example pornography, cocaine and second-hand clothes.

(g) *Voluntary export restraints:* This refers to the voluntary limits imposed by exporting countries on the exportation of certain commodities. It is bilaterally negotiated with an importing country to limit excessive exportation of goods to an importing country, which may harm trade relations between the two countries.

Arguments for Protectionism

Arguments which support protectionism are as follows:

(i) *Infant Industry Argument*

Protectionism helps to protect newly established industries against foreign industries which apply high technology in production. They are more cost effective, and thus produce goods of high quality at low cost, and are sold at low price.

(ii) *Anti-Dumping Argument*

The government protects home industries against the effects of dumping, whereby a country sells goods of low quality at low price in a foreign market, which affects domestic industries. Therefore, when tariffs are imposed on goods which are dumped, it helps to reduce the problem of dumping.

(iii) *Employment Promotion*

Protectionism helps to protect home industries and therefore create more job opportunities to the citizens.

(iv) *Balance of Payments Argument*

By applying protectionism measures such as devaluation, the payments to abroad, by the way of imports, decline and a country may also increase its exports and receipts of foreign currency, which improves the balance of payments of the country.

(v) *Retaliatory Argument*

Some countries impose tariffs to avenge against a country which has imposed tariffs upon their goods. For example, when the government of USA imposed high tariffs on steel products from other countries, the Europeans countries retaliated by increasing tariffs on goods from USA.

(vi) *To Control Inflation*
Protectionism is sometimes applied to prevent importation of goods from a country which is affected by inflation.

(vii) *To Avert Cultural Distortions*
Free trade may result in the importation of items which can destroy the good culture of a country. Due to this reason, countries impose control measures on goods or items which demolish the culture of a country. For Example, the items which can erode the culture of a country are pornography and drugs like cocaine.

(viii) *Reduce Dependency*
Importation may create economic dependency and thus, harm some political and economic interest of a country. To avoid this, several countries impose some restrictions to reduce excessive country's dependency on other countries.

Arguments Contra to Protectionism

Arguments which are against measures of controlling foreign trade are as follows:

(i) *Fall in Consumers Welfare*
Protectionism measures, such as tariffs, leads to an increase in the price of imported goods. In a situation of shortage of the domestic products, consumers suffer by buying imported goods at a much higher price. This increases the cost of living and decreases the welfare of the people. Moreover, the welfare of the people decline because they are forced to buy locally produced goods, which may be of poor quality.

(ii) *Danger of Inflation*
Import tariffs cause an increase in the prices of imports. In case these imports have inelastic demand, the demand for these goods will not fall by a large proportion, and wage earners will therefore demand higher wages so as to be able to purchase the goods. When the demand for high wages is realized, it may cause a wage spiral inflation.

(iii) *It is Contrary to the Law of Comparative Advantage*
The law of comparative advantage is the basis of international trade, it insists on specialization and free trade in order for each country to gain from international trade. However, if countries protect their industries, the law of comparative advantage does not apply and, therefore, countries do not gain from trade.

(iv) *It Lowers the Volume of Trade*
Protectionism discourages import and export and, therefore, reduces the volume of international trade.

(v) *It Discourages Competition in the Local Economy*
Protectionism assures local firms of markets for whatever they produce; this makes them less inventive in more efficient techniques of production, i.e. in discovering the methods of production that can enable them to produce goods of high quality at a low cost. The long run effect of this inefficiency is slow growth of the country's economy.

Effects of Tariffs and Quota

Tariffs and quota have the following effects:
(a) *Price effect:* As a result of tariffs, the price of imports may increases.

(b) *Protective effect on domestic production:* Tariffs lead to an increase in the domestic supply of goods.
(c) *Reduction in the demand for imports:* The demand for imports increase as a result of an increase in their prices.
(d) *Welfare effect:* The welfare of the consumers might fall because they may be buying at higher prices, but buying low quality domestic goods.

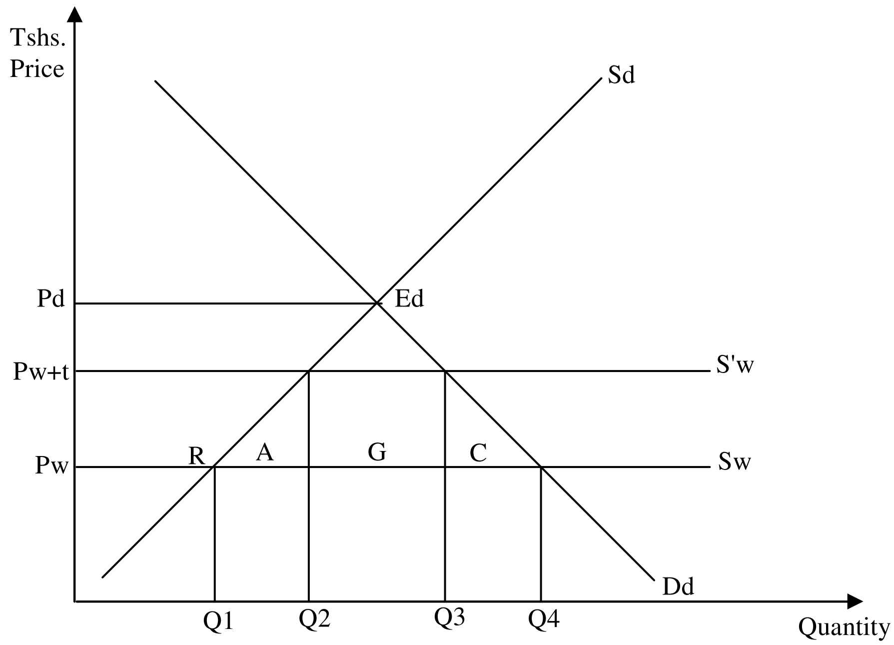


Figure 5.2: Impact of tariffs

In figure 5.2 above,
Dd - Is the domestic demand curve for a country.
Sd - Is the domestic supply curve for a country.
Sw - Is the world supply curve which is horizontal (perfectly elastic).
Pw - Is the world market price for a commodity.
Pd - Is the domestic price of a commodity.
With free access to the world market, i.e. without Tariffs;

- The domestic consumers will purchase Q4 of the product and the domestic producers will supply Q1. The differences, Q4 - Q1 is the imports.
- The world price, Pw, will now be the price of the product within the country.
- Also, the quantity supplied by the domestic producers will be less than the pre-trade quantity at price Pd (point Ed), but the quantity demanded will be greater than the pre-trade quantity.

Imposition of Tariffs

If an import tariff of amount *t* is imposed on each unit bought from foreigners, the result will be:

- The world supply curve will shift from Sw to S'w, because any amount of foreign output can now be obtained for price Pw + t.
- Demand for imports will fall fromQ4 to Q3.

- Domestic supply will rise from Q1 to Q2.
- The price of the commodity will increase from Pw to Pw + t
- The loss of welfare will be represented by areas, RAGC, due to the high prices and low quantity demanded.

The Case for and Against Free Trade

Free trade, in international trade, refers to the trade policy whereby a country eliminates all the trade barriers such as tariffs and import quota.

Arguments for Free Trade

Arguments for free trade are as follows:

(a) *Gain from the trade:* Free trade allows countries to gain from international trade through comparative advantage, whereby a country specializes in the production of a commodity which it has the greatest comparative advantage over the other countries.

(b) *Increase in the welfare of the consumers:* The welfare of the consumers of a country increases as a result of free trade because they are able to purchase varieties of goods, from abroad, at low prices but high quality.

(c) *Transfer of technology:* A country may acquire the technology from other countries through the goods imported and the direct foreign investments.

(d) *Increase in the efficiency of the local firms:* The efficiency of the local firms may increase because they are exposed to competition with more efficient foreign firms. With free trade, there are more incentives for the local firms to be more inventive than when they are protected through tariffs.

(e) *Increase in the Volume of the World Trade:* As a result of free trade, the volume of the world trade will increase, leading to improvement of the economies of scale in various countries.

Argument against Free Trade

Arguments against free trade are as follows:

(a) *Problems of specialization:* As a result of free trade and comparative advantage, a country may specialize in only one commodity and risk facing serious economic problems if the demand for the commodity, in the world market, declines.

(b) *Danger of dumping:* This is the selling of goods, in the foreign market, below their cost of production and, thus affecting goods from the industries of the importing country because they fail to compete with the dumped goods cheap from abroad.

(c) *It affects infant industries:* Free trade affects infant industries, i.e. industries which are still at the youngest level of establishment and cannot compete with the foreign well established industries.

(d) *It can aggravate unemployment problem:* Free trade may lead to the collapse of domestic firms and, thus increase in the unemployment problem.

(e) *Balance of payments problem:* Free trade may lead to an increase in import spending and, thus increase in the deficit in the balance of payments.

(f) *Importation of harmful products:* Free trade may result into the importation of some commodities which may be harmful to the citizens of a country such as expired medical drugs and food items.

(g) *A country may lose revenues:* A country engaging in free trade may lose revenues that it earns through tariffs.

Obstacles or Barriers to International Trade

International trade is affected by a number of obstacles or barriers as follows:

(a) *Tariffs and quotas:* Tariffs are taxes that are imposed on imports for the objective of either raising revenues or protecting industries, while quotas are the quantitative restrictions on the amount of imports, both tariffs and quotas reduce the volume of world trade.

(b) *Different languages among countries:* There are different languages that are spoken by people in different countries which, to some extent, affect the effective communication that is needed in international trade.

(c) *Currencies:* Foreign trade involves exchanging currencies, which in itself is a barrier, but it is often added to by the restrictions placed on currency exchange by the government.

(d) *Poor infrastructure in some countries:* In some countries, especially the less developed countries, infrastructure such as roads and railways are less advanced and, therefore, limit the efficiency of trade.

(e) *Political misunderstanding:* For international trade to grow, the level of understanding among countries must be high, but if there are political misunderstandings, international trade may not grow.

(f) *Geographical barriers:* Geographical barriers such as mountains, rivers, forests, wildlife, oceans can sometimes prevent smooth trade among countries.

(g) *Immigration laws:* Tight immigration laws and procedures can also be impediments to international trade.

Trade Creation and Trade Diversion

(a) *Trade Creation*

Trade creation is said to occur when a country starts to import goods from a low cost producing member country to replace imports from a high cost producing non member country after the abolition of tariffs.

(b) *Trade Diversion*

Trade diversion is said to occur when a country stops buying goods from a low cost producing non-member country and buy from a high cost producing member nation in integration because of the existence of common tariffs and quotas against goods from a non-member country. Suppose, for example, we consider three countries, Tanzania, Kenya and United Kingdom, the first two have free trade following the establishment of the East Africa Co-operation, and exercise common external tariffs against textile goods. Both Kenya and the United Kingdom produce textile products, but the Kenya's product is more expensive.

Without tariffs, both Kenya and Tanzania would import from the United Kingdom. The effect of the tariffs is that, Tanzania now buys the Kenya's textile even though they are more expensive to make, thus the pattern of trade is distorted and Tanzania consumers suffer, same to the United Kingdom exporters.

Importance of International Trade

International trade has the following advantages:

(a) *It encourages specialization:* International trade enables countries to specialize in the production of goods in which they have comparative advantage on.

(b) *Technological transfer:* International trade may facilitate the transfer of technology from one country to another country.
(c) *Economies of scale:* International trade widens market for a country's products and, therefore, enables local producers to produce in large scale.
(d) *It reduces scarcity of goods:* Since no country in the world is self-sufficient in everything, international trade reduces the deficit in the supply of commodities and, therefore, ensures a constant supply of goods in the domestic market.
(e) *Amplification of competition:* International trade exposes the local firms to foreign market, which is very competitive. These compel the local firms to adapt to the new techniques of production and modern marketing strategies and, therefore, improve the whole economy.
(f) *Stimulates international understanding:* International trade creates good mutual relationships among nations and among the citizens of the trading nations and, thus help to maintain peace and security in the world.
(g) *A country gets what it can't produce:* International trade enables a country to get what it cannot produce and sell what it cannot consume.
(h) *Dispose of the surplus products:* International trade enables a country to sell its surplus products that is the products, which remain after domestic consumption.
(i) *It's important during calamities:* International trade enables a country to obtain various necessities during calamities such as floods and droughts.
(j) *Foreign earning:* International trade enables a country to earn foreign currencies and revenues through tariffs.

Disadvantages of International Trade

International trade has the following disadvantages:

(i) *Decline of Domestic Industries*

International trade compels the local firms to engage in competitions with the foreign giant firms which use more efficient techniques of production. Such competitions lead to the collapse of domestic firms because of failing to compete against the foreign firms.

(ii) *Some of the Imports are Harmful to the Citizens*

For the sake of making profit, traders may import goods which may have economic, social and cultural effects. Examples of such goods are marijuana, cocaine, expired food and drugs, second hand goods, romantic literature, etc.

(iii) *Dependency*

International trade influences specialization among countries. Too much specialization may be dangerous to a country since it makes the country dependent on other countries for the supply of essential goods. These cause difficulties to the importing country when it faces problems of foreign currency, in which it can fail to import the essential goods. Dependency may also be a source of neo-colonialism.

(iv) *Problem of Unequal Exchange*

Most of the time, less developed countries faces unfavourable terms of trade because they export primary products, which have low price elasticity, and import manufactured goods, which have high price elasticity.

(v) *Defects of Specialization*

Too much specialization often leads to problems when the demand for the commodity decline in the world market.

(vi) *Unequal Exchange and Exploitation of Resources*

International trade may lead to massive exploitation of a country's wealth due to unequal exchange and transfer of wealth to abroad.

Problems Faced by Developing Countries in International Trade

Developing countries face a number of problems in international trade:

(a) *Declining terms of trade:* Most of the products that are produced by developing countries are sold at low prices due to reasons such as poor quality, oversupply of these products, discovery of synthetic substitutes and weak bargaining power.

(b) *Dependency on international trade:* Most of the developing countries are dependent on international trade for their development. For example, most of these countries depend on export sector to earn their income, therefore, in case of price fall; the economies of these countries suffer greatly. Also, these countries depend on import trade to acquire most of the essentials commodities such as oil; this makes them so vulnerable when the price of imports rises.

(c) *Protectionism policies of developed countries:* Developed countries often impose different kinds of protection measures against goods from less developed countries; this lead to fall in the exports of these products to developed countries.

(d) *Severe external debt due to deficit in the balance of payments:* Exports earnings are lower than the payments for imports due to low price of exports; this force developing countries to depend on foreign aid to finance its imports, hence an increase in foreign debt.

Theory of Exchange Rate

Exchange rate is the price of the domestic currency in terms of a foreign currency. It is the relationship between the foreign and the domestic currency. It is realized through international financial institutions that deal in the selling and buying of foreign exchange, e.g. 1 dollar = 1200 Tanzanian's currency.

Types of Exchange Rates

There are various types of exchange rates as follows:

A. ***Fixed exchange rate***

This is where the price of one currency, in terms of another, is maintained through the Central Bank.

Advantages of Fixed Exchange Rate

Fixed exchange rate has the following advantages:

(i) The fixed exchange rate system does not encourage speculation. Quite often, speculation and gambling tend to adversely affect the economy.

(ii) The fixed exchange rate programme encourages the inflow of capital, since it tends to remove possible uncertainties.

(iii) Monetary authorities are less prone to indiscipline. A fixed exchange rate system minimises the possibility of the financial/monetary authorities of encouraging an inflationary situation.

(iv) A fixed exchange rate system encourages a conducive atmosphere for regional economic integrations, since it promotes the harmonization of domestic policies by

the concerned countries as it makes the prices of commodities more realistic in international commodity markets. This, consequently, gives confidence and encourages more production for external markets, leading to high rates of economic growth and development.

(v) The fixed foreign exchange rate system enables people to gain confidence in the strength and value of the domestic currency, as there are no likely depreciations and appreciations.

(vi) The price predictability is quite possible. This encourages production and consequently high economic growth rates.

Disadvantages of Fixed Foreign Exchange Rates

Fixed exchange rate has the following disadvantages:

(i) The system could lead to massive misallocation of the scarce foreign exchange resources (capital/finance), as it imposes a heavy burden on the financial/monetary authorities in the control of foreign exchange resources and reserves.

(ii) Shortages in international liquidity may result, as the monetary authorities endeavour to minimise fluctuations beyond reasonable limits.

(iii) A fixed foreign exchange rate system would lead to inflation and high social costs, since the system could temper with prevailing stable situations of full employment.

(iv) The fixed exchange rate system needs a lot of foreign exchange reserves in order for it to operate successfully. This could consequently lead to a B.O.P problem/deficit/disequilibrium.

(v) At times, the system may result into either over-valuation or under-valuation of the country's domestic currency.

B. *Free/Flexible/Floating Exchange/Fluctuating Exchange Rate System*

This occurs when the exchange rate is determined by forces of demand and supply.

Advantages of Flexible Exchange Rate

Flexible exchange rate has the following advantages:

(i) The price of the domestic currency against the foreign currency is free and fair, since it is determined by the forces of demand and supply.

(ii) This foreign exchange system is automatic and indeed realistic.

(iii) The flexible exchange programme indicates the strength of the domestic currency.

(iv) Even the government can earn some revenue to finance its current and development expenditure.

(v) As compared to the fixed exchange system, it does not require a lot of foreign exchange reserves.

(vi) This system does not necessitate financial institutional, e.g. the World Bank, IMF, arrangements for borrowing and lending to curb the short term disequilibrium in B.O.P.

(vii) It avoids the competitive exchange rate depreciation among countries.

(viii) Curbing/controlling B.O.P pressures is easy than would be the case with a pegged foreign exchange rate system.

(ix) There are no rigidities in acquiring foreign exchange.

(x) It works well under a liberalized economy. The forex bureaux, through speculation, will supply foreign exchange to meet the private demands

Disadvantages of Free/Flexible Exchange Rates

Fixed exchange rate has the following disadvantages:

(i) Floating the currency can permit the transfer of inflation due to the highly priced goods and services.

(ii) Speculation may be encouraged. A flexible exchange rate has speculative effects among the traders, investors and consumers.

(iii) This system tends to increase the smuggling of the foreign currency; as foreign exchange is often sold on non-official markets when the speculators purchase it cheaply and sell them dearly (expensively).

(iv) This system has to depend on the markets mechanism, and yet this has several defects that may lead to misallocation of resources.

(v) The floating foreign exchange programmes, often, subject the domestic economy to price fluctuations. This will make employment and production difficult, since it will affect the planning system.

(vi) Again, due to the speculation, gambling and consequently instabilities may occur, leading to several uncertainties in the economy. Strategic plans for imports and exports will, therefore, be made difficult.

(vii) It leads to uncertainties in international trade, which may discourage trade among nations, and capital and financial resource movements.

(viii) It has proved inefficient in correcting a deficit in B.O.P since the domestic demand for domestic exports and imports remain inelastic.

C. *Multiple Exchange Rates*

This means that the foreign currency is purchased at different rates/prices by the local currency. This usually depends on the purpose for which foreign currency is required. For example, the exchange rate would be lower for importers of medicine and higher for importers of non-essential products (luxuries) or for tourists.

Advantages of the Multiple Exchange Rates System

Multiple exchange rates has the following advantages:

(i) This foreign exchange system avails foreign exchange to all that is needed for it.

(ii) The system enables the country to restrict foreign exchange, undertake foreign exchange control, so as to curb a B.O.P deficit.

(iii) It enables the nation to allocate foreign exchange to priority areas of production and to boost the country's domestic production.

(iv) The multiple exchange rate system can be used to fix different rates for importers.

(v) The system also checks on exports to and from the country's trading partners.

Disadvantages of multiple exchange rates system

Multiple exchange rates have the following disadvantages:

(i) Trade mal-practices could result. This may involve under-invoicing and over-invoicing of exports due to differences in foreign exchange rates.

(ii) It may distort international trade and hinder currency convertibility. This could affect the free movement of foreign exchange.

(iii) The multiple exchange rate system is quite expensive and indeed difficult to implement.

D. ***Pegged Foreign Exchange***

It is a system where the price of a particular domestic currency is fixed in relation to a given foreign currency. For example, in case the Tanzania shilling is pegged to the USA dollar and the prices of other foreign currencies are determined according to the dollar and shilling relationship.

E. ***Managed/mixed exchange rate***

This refers to that price at which the currency is exchanged according to the demand and supply for the foreign currency. It is the rate of exchange that can be changed/altered but within certain limits, and the Central Bank has to control such fluctuations.

Dual exchange rate system

This occurs when the country practices, both the fixed and the floating/free/flexible foreign exchange rates systems concurrently.

International Institutions in International Trade

(i) *IBRD:* This is the International Bank for Reconstruction and Development. It is popularly known as the World Bank. It was formed at the Bretton Woods conference as a separate institution of IMF in order to assist countries with serious problems.

(ii) *IFC:* It is the International Fund/Finance for Co-operation. The fund was formed in 1956 as an affiliate of the World Bank. It promotes investments in poor countries by assisting the private sector enterprises. It has its headquarters at Washington D.C.

(iii) *IDA:* It was formed in 1960 as an affiliate of the World Bank in order to promote economic development through long-term loans for the poor developing countries.

(iv) *GATT:* This is the General Agreement on Tariffs and Trade. The GATT came forward as a result of the 1947 General Conference. It is a multi-national treaty, encompassing 80% of the World Trade.

Objectives of GATT

GATT was established to meet the following objectives:

- To protect the domestic infant industries basically through tariffs.
- To control the powers and activities of multi-national enterprises/agencies/ organisations.
- To encourage the growth, development and more equitable distribution of gains from international trade.
- To harmonize and liberalize both the tariff and non-tariff measures to negotiations.

(v) *The UNCTAD:* This is the United Nations Conference on Trade and Development. It was established in 1964 to handle LDCs' trade obstacles. It was a result of the unfavourable North to South co-operation.

Objectives of the UNCTAD

UNCTAD has the following objectives:

- To give LDCs trade (tariff) preference through encouraging and promoting both manufactured and semi-manufactured goods.
- Strengthen and promote capital inflow to LDCs for development.
- Promoting self-reliance and economic co-operation among developing countries.

- Promoting/encouraging/stimulating economic growth and development, especially among developing nations.
- To improve the terms of trade among the least developed countries by enlarging the markets for their primary products, and also to stabilize prices through international commodity agreements.
- *The UNCTAD* also aims at transferring technology rapidly to LDCs. This would encompass capacity building, research and training for LDCs in an endeavour to narrow the technological gap between the developed countries and the LDCs.

(vi) *The World Bank:* Also known as IBRD, that is, the International Bank for Reconstruction and Development. It was established in 1945 as a sister institution of the International Monetary Fund (IMF). Indeed, the IMF members are members of the World Bank. It has the USA, UK, Germany, France and Japan as its major shareholders.

Objectives of the World Bank

The World Bank has the following objectives:

- To help in the restructuring and development of the member states through genuine and adequate investment capital.
- To encourage balanced growth in international trade and achievement of a fairer B.O.P position.
- The World Bank further promotes foreign investments, since private capital is often insufficient to fund productive projects.
- To finance projects/programmes like roads, railways, power, telecommunications, etc; aimed at improving the general welfare, especially among the poor population in LDCs.

(vii) *The International Monetary Fund (IMF):* IMF is an international financial institution which was formed after the Breton Woods Conference of 1944 and it came into operation in 1947.

Objectives of the IMF

The IMF has the following objectives:

- To assist member countries with severe B.O.P problems through provision of loans, technical, monetary advice and fiscal policies/programmes.
- To enhance foreign exchange stability and maintain orderly exchange programmes/policies among member states so as to avoid the competitive foreign exchange depreciation.
- To eliminate the unnecessary foreign exchange restrictions that may hamper trading among countries.
- The IMF also aims at providing technical assistance by sending experts to member countries that may need them.
- To promote international monetary co-operation, as a basis of consultation and collaboration on international monetary programmes.
- To assist in the establishment of multi-national systems of payments in respect to current transaction among member states.
- To establish and expand a balanced growth of international trade.

The IMF' Structural Adjustment Programmes (SAPs)

These SAPs include a package of the IMF's conditions, to less developed countries, for getting the IMF's assistance. These conditions include:

(i) Reduction in the government expenditure like the social overhead expenditure such as infrastructure, health, education, social security, etc.
(ii) Devaluation: The IMF stresses that this would improve the B.O.P position of developing countries by making imports more expensive than exports.
(iii) Improvement in tax collection: The IMF urges developing countries to expand their tax base, so as to raise more revenues.
(iv) Strict monetary and credit policies: The IMF recommends credit restrictions and an increase in interest rates, so as to reduce money supply and reduce inflation.
(v) Trade liberalization: LDCs are forced to liberalize their markets to foreign imports through their manufactured products, because their exports are often faced with restrictions by the developed countries.
(vi) Retrenchment of workers and demobilization: Again, the IMF recommends reducing the number of civil servants and soldiers. Though this is undertaken without proper consideration of the manpower requirements of LDCS' economies.
(vii) Wages freeze: This condition of the IMF, has, however, greatly affected the general welfare, especially among the working class.
(viii) Privatisation and encouragement of the private sector, where economic activities are to be shifted from the state to the private sector in a bid to ensure profitability, efficiency, proper management and accountability within the private sector.
(ix) Establishment of flexible foreign exchange rate policies: In this era of globalisation, the control of the state economic activities has greatly been reduced. Quite often, forces of demand and supply have been allowed to prevail, hence the need for a flexible/free floating exchange rate system.
(x) In the case of LDCs, the IMF still recommends and encourages increased production in the agricultural sector.
(xi) Where the state still controls the major means of production, the IMF emphasizes efficiency in public sector enterprises.

Achievements of the International Monetary Fund

The IMF has made the following achievements:

(i) The fund has assisted member states with balance of payments problems, by funding them so as to reduce the problem.
(ii) The fund has altered its original article to the changing international economic situation. For example, it has legalized free exchange rates, raised quotas to increase capital resources, etc
(iii) The fund has provided financial support, especially under the special import programme (SIP), which has led to an increase in a variety of commodities in the market.
(iv) The liberation policy of the IMF, especially on trade, has reduced problems of scarcity of goods in a number of less developed countries.
(v) Policies, such as privatisation, have improved efficiency, accountability, management and have also controlled corruption.
(vi) It has increased the inflow of foreign currencies to various countries.

Failures of IMF

The IMF has failed in the following areas:

(i) Controlling and restricting world trade.

(ii) The fund's lending rates are high and short term, and indeed, with high interest rates.

(iii) The IMF tends to discriminate against LDCs in favour of developed countries who are the major shareholders.

(iv) Following the collapse of the Brettonwoods system, under which the fund was established, the IMF has failed to promote foreign exchange stability and orderly exchange among the member states.

(v) The IMF has tended to interfered with the internal economic affairs/conditions of its member states. This is because the member countries have to fulfil the IMF's conditions before getting financial assistance.

(vi) The IMF's policies have instead widened the gap between the poor and the rich in LDCs. This is because such programmes have mostly favoured the richer sections of the population.

(vii) Standards of living have deteriorated because of the strict IMF conditions of increasing taxes so as to widen the tax base.

(viii) Foreign exchange wastage has become a common problem in LDCs due to the IMF's liberation conditions, which has led to the importation of unnecessary goods.

(ix) Increased debt burden has resulted in a bid to stabilize the B.O.P position as required by the IMF.

(x) Retrenchment has aggravated the problem of unemployment and this, too, has affected people's welfare.

(xi) The IMF policies have failed to protect the peasant farmers in LDCs, because of the abolition of price control programmes, e.g. minimum price legislation.

(xii) Privatisation conditions of the IMF have greatly affected the locals, since they do not possess enough capital to purchase expensive state enterprises that have been sold off.

(xiii) Cost sharing in the education sector, as a condition of the IMF, has led to rampant school drop outs, resulting into many semi-illiterates and unemployed.

(xiv) Generally, the IMF policies have proved to be unpopular. This is because formerly, the government's pro-people expenditures have been stopped.

Review Questions

1. What is international trade?
2. Describe theories of international trade.
3. What is the main difference between theory of absolute advantage and comparative advantage?
4. Write short notes on the following:
   (i) Balance of trade.
   (ii) Balance of payments.
   (iii) Terms of trade.
   (iv) Invisible balance
5. What are the major accounts in balance of payments?
6. Discuss the main causes of deterioration of terms of trade
7. Discuss how a deficit balance of payment can be corrected.
8. Discuss the impact of tariffs

9. To what extent can devaluation help in solving balance of payments problems
10. Explain the importance of international trade
11. What is the argument for and against protectionism?
12. Discuss the *pros* and *cons* of free trade.

CHAPTER SIX

ECONOMIC INTEGRATION AND CO-OPERATION

Meaning

Economic integration is the combination of selected economies so as to trade freely among member countries.

Forms/stages of Economic Integration

Economic integration has the following stages:

1. ***Free Trade Area***

It is the type of integration in which countries remove all the trade barriers, so as to trade freely among member countries, but each member country maintains the unilateral right to impose tariffs on goods from the rest of the world.

2. ***Customs Union***

This is a type of integration in which member countries remove the trade barriers among themselves, but have common tariffs against the rest of the world.

3. ***Common Market***

In this type of integration, member countries have customs union, hence allow a free movement of the factors of production from one member country to another member country.

4. ***Economic Union***

In this type of integration, member countries, besides having a common market, establish joint institutions such as railways, roads, parliament etc.

5. ***Common Monetary Union***

In this type of integration, member countries establish a common currency.

Stages of economic integration can be summarised using table 6.1 bellow:

Table 6.1: Forms/ stages of regional integration

STAGE	Countries remove all trade barriers on trade	Each member country maintains unilateral right to impose tariffs on goods from the rest of the world	Common tariffs against the rest of the world.	Free movement of factors of production	Countries establish joint institutions such as railways, roads, parliament etc	Member countries establish a common currency
Free Trade Area	√	√				
Customs Union	√	√	√			
Common Market	√	√	√	√		
Economic Union	√	√	√	√	√	
Common Monetary Union	√	√	√	√	√	√

The Necessary Conditions for a Successful Economic Integration

In order for an economic integration to be successful, the following conditions are necessary:

(i) *Good Infrastructure:* In order for economic integration to be successful, countries in the region of integration must be having good infrastructure that may facilitate the movement of goods and people from one area to another.

(ii) *Political Will and Commitment:* For a regional integration to be successful the political leaders must be willing and committed to implement the various resolutions that are made. They must also have the political ability to make necessary decisions for the betterment of the integration.

(iii) *Common Language:* Common language, ability among the people in an economic integration, facilitates easy communication among the people in the region as they engage in socio-economic and political activities.

(iv) *Common Currency:* In order to have a smooth exchange, a common currency is very important for integration. Absence of a common currency makes exchange difficult.

(v) *Differentiated Products:* Exchange cannot take place if countries produce similar products. Each country should, therefore specialize in a commodity which it has comparative advantage.

(vi) *Trade Gains:* For an integration to be successful, each member country must gain from trade. If some member countries do not gain from trade or any other economic activities, then the integration will not be successful.

(vii) *Similar Level of Development:* In order to reduce uneven distribution of gains among the member countries, countries should have similar level of economic development, if the difference in the levels of development is so wide; the rich members will gain more than the poor countries.

(viii) *Member Countries Must Be Neighbours:* It is easier for member countries to engage in economic activities and establish joint institutions if they are close neighbours, in terms of geographical location, than when they are located far from each other.

(ix) *Cultural Similarities:* Cultural similarities facilitate the interactions among the people in various economic activities such as trade and investments.

(x) *Trade Creation:* Trade creation is said to occur when a country, in an integration, now imports goods, at a low cost, from a member country after abolition of tariffs.

Importance of economic integration

Economic integration has following importance:

(i) *Enlargement in the Markets:* Economic integration leads to abolition or reduction of trade barriers among the member countries. The abolition of trade barriers increases the size of the market for the goods produced by the member countries.

(ii) *It enables member countries to specialize:* Economic integration enables each member country to specialize in the production of a commodity of its comparative advantage. Specialization leads to increase in output and gain from trade.

(iii) *Transfer of technology:* Integration leads to exchange of technology among the member countries.

(iv) *Increase in employment:* There are possibilities of attaining increase in employment due to the free movement of the factors of production and expansion in investments.

(v) *It reduces exchange difficulties:* In monetary union, countries adopt a common currency which eliminates all the difficulties that traders of different countries face when they use different currencies.

(vi) *Increase in political and social understanding:* Economic integration promotes good political relationships between the governments of the member countries and between the people of the member countries.

Problems of economic integration

Economic integration faces the following problems:

(i) *Uneven Distribution of Gains:* The distribution of gains among the member countries may differ due to the different levels of economic development among the member countries and unfavourable terms of trade.

(ii) *Political Instabilities:* Civil wars and political misunderstandings between one member country and another may hinder the development of economic activities, such as trade, among the member countries.

(iii) *Differences in Political Ideologies:* The differences in political ideologies among the member countries make it difficult for the member countries to have common objectives and approaches in implementing their objectives.

(iv) *Poor Infrastructures:* For an economic integration to be successful, there must be a reliable infrastructure in the region. The absence of roads, railways and other means

of transport and communication hinder economic activities such as trade among the member countries.

(v) *Loss of Revenues:* Economic integration leads to loss of revenues with the member countries, due to the removal of tariffs.

(vi) *Differences in Currencies:* In case the member countries use different currencies, exchange among them becomes difficult.

(vii) *Differences in Language:* In case the member countries have different national languages, it causes difficulties in communication among people in various activities such as trade.

(viii) *Trade Diversion:* Trade diversion is said to occur when a country stops buying goods from a low cost producing non-member country and buys from a high cost producing member nation, within the integration, because of the existing common tariffs and quotas against goods from non-member countries.

Suppose, for example, we consider three countries, Tanzania, Kenya and the United Kingdom, the first two have free trade, following the establishment of the East Africa co-operation, and exercise common external tariffs against textile goods. Both Kenya and the United Kingdom produce textile products, but the Kenya's textile is more expensive. Without tariffs, both Kenya and Tanzania would import, from the United Kingdom, but the effect of the tariffs is that Tanzania now buys Kenya's textile even though they are more expensive, thus the pattern of trade is distorted and Tanzania's consumers suffer, same to the United Kingdom exporters

EXAMPLES OF REGIONAL INTEGRATIONS

The ECOWAS

ECOWAS is the Economic Community of West African States. It was formed in 1975, and comprises of 16 West African states, namely, Ghana, Cameroon, Chad, Nigeria, Togo, Benin and Niger. It also has Ivory Coast, Senegal, Sierra Leone, Gambia, Gabon, Mali, Liberia, Burkina Faso and Mauritania.

Aims of the ECOWAS

The ECOWAS has the following aims:

- To bring closer relationship in economic and social development.
- To make good trading relationship in goods and services between the member states.
- To create economic liberation among the member nations.
- To cooperate in communication, transport, energy, agriculture, industries, trade and other natural resources.

Achievements of the ECOWAS

ECOWAS had the following achievements:

- Some trade barriers in the region have been removed.
- Abolition of VISA for short-term residences among the member states.
- Improvement in telecommunication network.
- Proposals to introduce a common currency.
- Management of peace in conflict areas such as Liberia.

Problems of the ECOWAS

The ECOWAS face the following problems:

- Vastness of the area that is covered by the ECOWAS; it has many member stops.

- Communication barriers among the member states.
- Differences in the languages that are spoken in the region.
- Deteriorating terms of trade between the member states and the rest of the world.
- Differences in currencies.
- Persistent civil conflict in the ECOWAS area such as Liberia.
- The division of the ECOWAS countries into Franco-phone and Anglo-phone.

The East African Community (EAC)

The origin of the East African community dates back to 1923, when governors of Tanganyika, Kenya and Uganda formed the African governors' conference. In 1948, the East Africa high commission replaced the East African governors' conference.

Aims of the East African High Commission

The EAC has the following aims:

- To administer common services such as East African civil association, East African posts and telecommunication etc.
- To make laws relating to inter-territorial common services, peace and order and the good governance of the colonies.

Establishment of the East African Community

On 6th June, 1967, the presidents of Kenya, Tanzania and Uganda signed the East African co-operation treaty in Kampala, Uganda. The treaty came to be effective on1st December, 1967. The headquarters for the community was in Arusha Tanzania.

Aims of the Former East African Community (EAC)

- To promote free trade in the area.
- To provide common services such as railways, posts, telecommunication, airways etc.
- To provide a wider and more secure market for the goods produced in the region.
- To facilitate free movement of people in the region.
- Running research services on sectors such as agriculture, medicine and population.

Reasons for the Collapse of the Former East African Community

The following are some of the reasons for the collapse of the former East African Community.

- Dissatisfaction among the member countries. Other member countries complained that Kenya was gaining more than the other two member states.
- Differences in political ideologies among the member countries hindered the implementation of some objectives.
- Political misunderstanding among political leaders, especially between the president of Tanzania and the president of Uganda.
- There were no clear and agreed patterns of industrial specifications, such that each member country insisted working on its own plan, while expecting to enjoy the benefits of the community.
- The government of Tanzania restricted free transfer and exchange of currency. This discouraged interstate transaction of goods. The restriction meant that, while in Kenya and Uganda, Tanzanians could not purchase goods and services because their currency was not acceptable in those countries. This discouraged interstate trade relationship among the member countries.

- The failure of the East African development bank to provide enough credits to economic sectors which were in need of funds.
- The ousting of president Milton Obote of Uganda from power, by Iddi Amin in 1971, created misunderstanding between Tanzania and Uganda
- The volume of trade among the member countries was very low.

The New East African Community

The treaty of the new East African community was signed in Arusha on 30th November, 1999, and came into force in 7th July, 2000. This is the association of five countries, these countries are: Tanzania, Kenya, Uganda, Burundi and Rwanda.

Goals and Objectives of the New East African Community

Widening and deepening co-operation among partner states in the following areas:

- Economic
- Political
- Education
- Science and technology
- Defence and security
- Health and
- Judicial and legal system.

These objectives may be achieved through the establishment of a custom union, as the entry point of the community, a common market, subsequently a monetary union and ultimately a political federation for the East African states.

Strategies for achieving the objectives

The following are the strategies for achieving objectives of the East African Community:

(i) Promotion of sustainable growth and equitable development of the whole region of East Africa, including rational utilization of the available resources and protection of the environment.

(ii) Strengthening and consolidation of the long standing political, economic, social, cultural and traditions between the people of East Africa, in order to promote people-centred integration.

(iii) Enhancing and strengthening of the participation of the private sector and the civil society.

(iv) Mainstreaming of gender in its entire programmes and enhancing the role of women in development.

(v) Promotion of good governance, including adherence to principles of democracy, rule of law, freedom of expression, transparency and gender equality.

(vi) Promotion of peace, security and stability within the region and good neighbourhood among the partner states.

Organs of the East African Community

The main organs of the East African community are:

- Summit of the heads of state of the member countries.
- Councils of ministers.
- Coordination committee.
- Sectoral committees.
- East African court of justice

- East African legislative assembly
- A secretariat

Strategies of the East African Co-operation

- The East African community operates on the basis of a five-year development strategy. The strategy spells out the policy guidelines, priority programs and implementation schedules.
- Emphasises on economic co-operation and development with a strong focus on the social dimension.
- Enhancing the role of the private sector and civil society in collaboration with the public sector in regional integration and development.
- Establishment of an internationally competitive single market and investment area alongside the development of regional infrastructure, human resource, science and technology.

Areas of Co-operation in the East African Co-operation

The following are the areas of co-operation among the member countries of the EAC.

- Trade, investment and industrial developments.
- Monetary and fiscal affairs
- Infrastructure and social services
- Human resources
- Science and technology
- Free movement of the factors of production
- Agriculture and food security
- Environmental and natural resources management
- Tourism and wildlife management
- Health, social and cultural activities
- The role of women in socio-economic development
- Participation of the private sector and the civil society and
- Co-operation in political matters including defence, security, foreign affairs, legal and judicial affairs.

Funding

The core budget of the East African Co-operation is funded by equal contributions from the member states, Regional programmes are funded through the mobilization of resources from both within and outside the region.

Problems of the East African Community

The East African Community is facing the following problems:

- Poor transport and communication systems which discourage economic activities among the member state.
- Political instability within individual countries, for example, in Uganda, there are frequent wars between the government forces and rebels.
- There is a small size of the market in the region due to low income among the people
- Lack of funds which limit the community's to implement some projects.
- Uneven distribution of gains among the member states due to different levels of economic development.

- There are few goods for exchange and the volume of trade is low because all the East African countries produce similar primary agricultural products and have a low level of industrial development.
- Weak private sector, in the region of East Africa the private sector is incapable of utilizing the available resources and establishing large trade relationships.

Factors that Favour East Africa Co-operation

The following are factors that favour East Africa Co-operation:

(i) *Common Language:* People of East Africa speak the same language, Kiswahili. This facilitates effective communication in various Economic, social and political relationships among the people of East Africa.

(ii) *Political Commitment and Will:* The political leaders of the East African states are very committed to implement various decisions and implement the objectives of the community.

(iii) *Political Stability:* The region of East Africa is relatively more peaceful than other regions of Africa. This provides a conducive environment for investment, by both foreign and local investors. Also, it allows for free movement of people from one state to another to engage in economic activities such as trade.

(iv) *Abundance of Natural Resources:* The region of East Africa is endowed with natural resources such as minerals, fertile soil and good climatic condition which attract more investments.

(v) *Infrastructure of the Former East African Community:* The current East African community still enjoys some of the remaining infrastructure of the former East community, such as its former Head quarter in Arusha, Tanzania, which was used as the ground for the formation of the new East African Community.

Benefits of the East African Community to the member states

(i) *Expansion in the Size of the Market:* A combined population of all the countries of East Africa makes a total population of about 80 million people. This creates a very big chance of market for traders in the region.

(ii) *Economies of Scale/Mass Production:* Producers in the member countries are expected to enjoy economies of scale due to expansion in the size of the market

(iii) *Attraction of Foreign Investment:* There is attraction of foreign investments as a result of removal of some trade barriers, such as tariffs and creation of a wider single market.

(iv) *Mobility of Resources:* There is increase in the mobility of resources, such as labour and capital, in the region from one member state to another. That mobility has increased employment opportunities, reduced cost of labour and increased the utilization of resources.

(v) *Political and Social Understanding:* East African co-operation has increased the understanding among the leaders and the people of East Africa.

(vi) *Technological Transfers:* The community has opened chances for transfer of technology from one member state to another. A technologically backward nation benefits from the technologically advanced nation.

Expected costs to member countries

Member countries in the East Africa Community, despite the gains, are likely to incur the following costs:

(i) *Uneven distribution of benefits:* In this co-operation, a more economically strong nation is likely to gain more than a less economically strong nation. A more economically strong nation benefits from the increase in the size of the market and more opportunities for investments in other countries. Nonetheless, these benefits are unlikely to be obtained by economically weak nations.

(ii) *Decline of infant industries:* Due to the removal of tariffs, the infant industries in some member country are likely to lose markets for their products, since they may not compete against industries in other nations that are more advanced.

(iii) *Loss of revenue:* The government revenues, in form of tariffs, declines due to the removal of tariffs.

(iv) *Capital and brain drain:* The factors of production, such as labour, tend to move from where they are paid less to where they are paid much higher. This, again, is probable to affect an economically backward member nation.

(v) *Demerits of specialization:* East African co-operation enables each member state to specialize in the production of the commodity in which it has a comparative advantage, however, specialization can cause serious problems to the member countries in case of price fluctuation of the commodity of specialization.

What should Tanzania do in order to benefit from the EAC?

Tanzania is currently the least advantaged in the EAC as compared to Kenya and Uganda. It is relatively poor, and faces a lot of challenges from her counterparts. The level of education, as well as science and technology, are the crippling factors in her attempt to enjoy the economic advantages that the EAC may bring. In order to realise economic benefits from her membership in the EAC, the following should be done:

- The quality of education has to be improved in order to ensure the production of competitive manpower that can be absorbed in various places in East Africa. Currently, the quality of education in Tanzania is so disappointing to the point that it does not instill confidence in the Tanzanians that they can compete with the Ugandans and Kenyans in the job market.
- Health services have to be improved in order to have energetic manpower that can effectively utilise the local resources for sustainable development.
- The country should continue maintaining peace and security in order to attract more investors and tourists into the country.
- The government should strive to improve local industries and agricultural sectors in terms of capacity and quality of goods produced, in order to compete in the regional market.
- The country should also work hard to improve its infrastructure which is largely dilapidated in many places. Infrastructure like road network and railway system, as well as telecommunication system will facilitate transport and communication within the country, which, in turn, will promote internal trade and industrial development. Trade and industrial development will, in turn, lead to fast economic development to compete with Kenya and Uganda.
- There should be improvement in the power supply system. Reliable power supply system will stimulate industrial development and, in turn, propel the economic

development of the country. Hence, various sources of energy and power have to be put in place so as to do away with the current erratic power supply system that has been hindering effective economic development.

- The country has to continue conserving the environment and ensuring proper utilisation of the environmental resources.
- The government should work out the programme under which it will keep on collecting public views on the fast-tracking of the regional political federation that the member countries are struggling for.
- Mass awareness campaigns to sensitise Tanzanians on the need to support the EA's federation have to be conducted. In other words, the local people have to participate in various activities that are geared towards realising the attainment of the EA's political federation.

The Southern Africa Development Community (SADC)

SADC is the association of seven countries from central and southern Africa, these countries include Angola, Botswana, Lesotho, Malawi, Namibia, Mozambique, Swaziland, Zimbabwe, Tanzania, Zambia, and the republic of South Africa, which joined in 1984. The SADC was formed to replace the former Southern African Coordination Conference (SADCC) which came into existence in April 1980 with the overall objectives of:

- Helping Southern African states to become self -reliant and reduce dependency on the Republic of South Africa.
- Attaining regional integration
- Mobilizing resources
- Securing international understanding

In April 1993, the heads of states of the member countries held a meeting in Mbabane, Swaziland, to ratify a treaty to change SADCC into SADC.

Objectives of the SADC

The SADC has the following objectives:

(i) To help member states to secure genuine and equitable regional integration.
(ii) To mobilize resources from the region and elsewhere that may be beneficial for all the member states.
(iii) To foster international co-operation.

The above aims are to be achieved through:

- Improved trade arrangement among the member countries.
- Improved transport and communication links and systems.
- Development of agriculture and industries.
- Developing and harnessing of energy resources.
- Developing and training manpower.
- Use of appropriate financial policies.
- Reduction of dependency on other nations.

Problems Facing the SADC

The SADC is facing the following problems:

(i) The SADC states tend to cater for their own national interests first before those of SADC

(ii) Member nations have attained different levels of economic development; hence there are uneven levels of development among the member nations.
(iii) Lack of qualified and skilled personnel to run the integration, hence they depend on technical assistance from developed nations.
(iv) Weak financial base which forces the member states to depend on foreign assistance.
(v) Most of the member states produce similar agricultural products such as coffee, cotton, maize and tobacco. Therefore, they fail to make exchange among them.
(vi) Deteriorating terms of trade in the world market.

The Common Market for Eastern and Southern Africa (COMESA)

Before 6th November, 1993, COMESA was known as the preferential trade area for Eastern and Southern Africa (PTA).

Objectives of the COMESA

The COMESA was established to achieve the following objectives:

- To promote and facilitate co-operation among the member states in trade, industry, agriculture, transport and communication.
- To harmonise and coordinate development strategies, policies and plans within the region.
- To improve the environment for investment and growth of the private sector.
- To encourage co-operation in monetary affairs in order to facilitate sub-regional integration.
- To establish joint industrial and agricultural institutions with the aim of increasing the sub-region's production capacity.
- To make trade much easier within the region through a reduction, and eventually reducing tariffs by 80% by the year 1996, and the introduction of a common currency in the year 2005.
- To build a strong economic base for its members as a step towards the economic independence of the region.
- To improve the security and overall welfare of the people.

Achievements of the COMESA

Since its establishment, the COMESA has had the following achievements:

- Tariffs has been reduced
- The member states have become more co-operative in the field of trade, industry and agriculture.
- The organisation has launched a bank, which finances trade and development projects. The Headquarters for the Bank is in Bujumbura, Burundi.
- The volume of trade has increased among the member states.
- The COMESA has its own currency.
- The number of members has been increasing.

Problems Facing the COMESA

The COMESA is facing the following problems:

- Uneven levels of economic development; some member states are poorer than other member states.

- Differences in the values of currencies discourage trade among member states, since it becomes more expensive for a country whose currency has a lower value, to import from a country whose currency is stronger, in terms of value.
- Lack of commitment among the members towards the implementation of the objectives set by the organization. Some member countries are reluctant to reduce tariffs.
- Differences in languages used by member states, some of the different languages which are used by member states include, Portuguese, English and French. These differences in languages affect effective communication among the people when they come in contact for economic activities such as trade.
- Reluctance of some member countries, such as Rwanda, to reduce tariffs as agreed by the other member states.

Achievements of the COMESA

Since its establishment, the COMESA has made the following achievements:

- Member countries have become more co-operative in the field of trade, industry, and agriculture.
- The organization has launched a Bank, the trade and development bank, which finances trade and development projects, its headquarters is in Bujumbura, Burundi.
- The COMESA has created its own currency.

Tanzania and the COMESA

Tanzania officially pulled out of the COMESA in September 2000.

Reasons for Tanzania's Withdrawal from the COMESA

Tanzania pulled out of the COMESA due to following reason:

- Tanzania was experiencing trade imbalances against other members; its balance of trade had been unfavourable for some years.
- More contributions due to multiple memberships of Tanzania in other regional groupings such as East Africa co-operation and SADC which had similar objectives.
- Tanzania depends much on revenues from import tariffs, which it was losing by being a member of the COMESA.
- The low level of industrial development made Tanzania to be only a market for goods from other more industrialized members such as Zimbabwe and Kenya. This could affect the development of the industrial sector.
- There was problem of dumping of goods from more industrially developed countries.

Impacts of the Withdrawal from the COMESA

The following have been the impacts of Tanzania's withdrawal from COMESA:

- Decline in the market of Tanzania's goods in other COMESA members
- Revenue through tariffs can be recollected
- Goods from COMESA countries are more expensive
- Transit charges through COMESA countries are high

The European Economic Community (EEC)

The Origins of the Community, as the common market, came into existence. Once again, the UK participated in early negotiations but then withdrew.

After two earlier abortive attempts to join the EC, the UK finally became a member in 1972, together with Ireland and Denmark. Norway decided, by a referendum, not to

become a member. Greece became a member in 1981, and Spain and Portugal joined in 1986. The introduction of the single European Act, in 1987, completed the process by which these twelve economies function as one.

The main features of the European Economic Community

There are two main features of the EC.

(a) *Customs Union:* The establishment of a full customs union involves both the abolition of tariffs between the members and the erection of a common external tariff to the rest of the world; if each country did not have the same external tariff, then imports would simply flood the community through the member states with the lowest tariffs. To arrive at the common external tariff, the general policy has to take the arithmetic mean of the previous six tariffs. In some cases, e.g. the imports of products from France's tropical ex-colonies, the lowest duty was adopted since there was no conflict with domestic production. Several of the old colonial states have associated status with the EC. The original arrangement for these states was superseded by the Lome Convention in 1975. Under this, 46 developing nations in Africa, the Caribbean and the Pacific (ACP states) are allowed to send all their industrial exports and most of their agricultural exports to the EC duty free.

When the UK joined the EC, it was particularly difficult for her to agree to the common external tariff because she wanted to protect Australia, Canada and New-Zealand. The agricultural products of the highly efficient farmers in these temperate countries were in direct competition with European farmers. The UK was not allowed to join until she agreed to erect considerable tariff barriers against her Commonwealth partners.

(b) *Common Market:* The EC is colloquially known as the Common Market, but this is only one aspect of its organisation, although potentially the most important. The term refers to the running of the economies of the members as if they were one, i.e. the common prices and production policy of the ECSC was to be extended to all industries. The common market agreement implies a free movement of labour, capital and enterprise within the EC. So far, it is only in the Common Agricultural Policy (CAP) that has a truly common policy. Despite the fact that the EC has been in existence since 1957, it is only in 1992 that a true common market was created.

The structure of the European Economic Community

The Treaty of Rome envisaged that the EC would eventually lead to economic and political unity although this has become more unlikely at present, than it seemed some years ago, it is possible to discern the four essential components of state organisation.

(i) *The Council of Ministers:* This could be described as the executive or cabinet of the EC. It consists of one minister from each state. The choice of minister depends on what is being discussed. If, for instance, the issue is agriculture, then it would be the ministers of agriculture who attend. Voting in the council is weighted; the U.K, for example, has ten votes while Luxembourg has only two. The council is assisted by a committee of permanent representatives.

(ii) *The European Commission:* This consists of 17 permanent commissioners; two from each of the five largest countries and one from each of the other seven. The commission is the secretariat of the EC. Behind the commission are staffs of about 2500 people working in the commission's headquaters in Brussels. The commission is

responsible for the day-to-day running of the community. It is also responsible for the development of the EC policies.

(iii) *The European Parliament:* The institution which meets in Strasbourg is the embryonic legislature of the EC. Originally, it consisted of MPs nominated by national parliaments. However, since 1979, members have been elected directly to the European Parliament. At present, there are 518 members of the European Parliament (MEPs), of which the UK elects 81. As yet, the Parliament still has little authority or power. Its main function is to monitor the activities of other institutions of the EC.

(iv) *The European Court of Justice:* Not to be confused with the European court of Human Rights, the function of the European court of justice is to ensure that the law is observed in the interpretation of the Treaty of Rome. It is the final arbiter on all the questions involving interpretation of the EC treaties, and it deals with disputes between member states and the commission, or between the commission and business organisations, individuals or EC officials. It is, thus the judiciary of the EC.

Objectives of European Economic Community

European Economic Community was established to achieve the following objectives:

- To harmonise policies for improving the living standards of the people of the member countries.
- Removal of traffic and non-traffic barriers among the countries.
- To encourage coordination and co-operation in trade customs and to be harmonised and standardised.
- To ensure that national business policies do not harm other members to adopt the common agricultural policy (CAP) for internal price support and variable import levies aiming at protecting the farmer in the community from foreign competition.
- Adoption of a common transport policy as regards development and the regulation of road, rail and inland water transport.
- Establishment of a common link with developing countries through other sub-organizations like ECC-ACP agreements.
- Establishment of a bank (European Investment Bank) to finance the economic developments, give grants, loans, aids etc.

Success of the European Economic Community

- It has emerged as the tightest association with well-stipulated policies.
- It has progressed further into trade and the general economic integration. European countries began using the EURO-Currency on 1st January, 2002. This is a great achievement, though there are some of the people who still doubt the future use of Euro-Currency.
- By 1967, most restrictions on trade were removed and the common external tariff could be into operation.
- The farmers receive high prices for their products, which has encouraged the promotion of agricultural performance in the European countries.

Failures/Problems facing the European Economic Community

The European Economic Community is facing the following problems:

- Establishing a common currency has been achieved with many difficulties, and there are some member countries, such as Britain, which have not joined the Euro-Currency.

- There is a problem of aging of the population due to the strict policies on family planning that focuses on birth control. This will lead to the problems of labour scarcity, hence deceleration of the economic growth due to inefficiency in the production process.
- There are difficulties in integrating agricultural development because of the large agricultural population of the member states.
- There have been problems associated with overproduction due to the increase of efficiency caused by the use of machinery. Overproduction has led to the decline in the prices of agricultural commodities. Tanzania is related to the EEC through membership in the Lome convention.

International Economic Co-operation

International economic co-operation refers to the relations which are established between sovereign states. The relations are usually established at political, economic, diplomatic and cultural levels. International Co-operation can take two forms

(i) Bilateral economic co-operation: This is the co-operation between two countries or two independent organisations

(ii) Multilateral economic co-operation: This is the co-operation that involves more than two countries.

Importance of Economic Co-operation

Economic co-operation has the following importance:

- It leads to an increase in the volume of trade among the partner countries.
- It leads to an increase in foreign investments.
- Improves the welfare of the people through varieties of goods consumed at lower prices.
- Political understanding is enhanced through economic co-operation.
- Transfer of technology increases through economic co-operation.
- Countries enjoy comparative advantage through economic co-operation.
- The size of the markets expands, thus enabling economies of scale to the firms in the cooperating countries.
- It increases mobility of labour and increases employment.

Disadvantages of Economic Co-operation

Economic co-operation has the following disadvantages:

- It can create economic dependency.
- In some cases, it may lead to capital drain.
- Uneven distribution of gains may occur.
- It can bring the effects of specialization if economic co-operation influences a nation to specialise in a certain product, which often leads to problems when the demand for the commodity declines in the world market.
- Unequal exchange and exploitation of resources. Economic co-operation may lead to massive exploitation of the country's wealth, which due to the unequal exchange and expatriation of wealth abroad.

Differences between Economic Co-operations and Regional Economic Integrations

Economic Integration and Economic Co-operation differ in the following ways:

(i) Regional economic integrations are confined to a certain geographical area of the continent, while economic co-operations have no regional boundaries. Economic co-operations involve countries of different regions in a continent or world.

(ii) It is necessary for countries in a regional economic integration to have similar levels of economic development, but that is not a necessary factor for international economic co-operation, since countries of different levels of economic development can establish economic co-operation, as it is the case of Lome convention and AGOA, which are co-operations between a group of poor countries and EEC, and between America and African countries, respectively.

(iii) Regional economic integrations usually involve the removal or reduction of trade barriers such as tariffs, while an economic co-operation may exist without eliminating the existing barriers.

(iv) Trade forms an important area of co-operation in a regional integrations while, in an economic co-operations countries can cooperate in non trade economic activities such as joint investments and exchange of technology.

(v) There is a definite organisation structure in regional integrations, but it is not so important in economic co-operations, since countries can cooperate without having any formal organs or organisation structure.

(vi) Similar political and social background is very important for regional economic integrations but it is not important for economic co-operations. Countries may still have economic co-operations even if they have different social political backgrounds. For example, one of the reasons for the success of the East Africa Co-operation is the similarities in political, cultural and social background among the five member countries. On the other hand, there may be no political and cultural similarities between Tanzania and Japan, but there is a strong economic co-operation between the two countries.

Examples of International Economic Co-operations

The Lome Convention

This includes a series of trade and economic co-operation agreements between EEC and countries from Africa as well as Caribbean and the Pacific states (ACP). The first Lome convention was signed in 1976 at Lome, in Togo, by EEC and 46 ACP countries. The second signing was effected in 1979 with emphasis on agricultural development, energy policy etc. The third Lome Convention came into force on 1st March, 1985, with the emphasis on the EEC assistance to ACP, sectoral programmes and further emphasis on some of the terms put forth in the earlier convention. The forth Lome Convention was conducted in 1990 in Kampala, Uganda, with emphasis on the increased co-operation between the EEC and ACP countries in areas of trade, industry, agriculture, fight against HIV/AIDS etc. However, the countries are still rigid to allow free trade in textiles.

Basic Provisions of the Lome Convention

(i) *Trade co-operation:* Goods from ACP countries should have a free access into EEC; free from customs duty and other charges. There is regular consultation on all matters concerning trade between the EEC and ACP. Also, the EEC conducts basic training and advanced vocational training in trade for ACP state staff.

(ii) *Protection of ACP Industries:* The ACP countries may impose tariff against the industrial products from the EEC to protect ACP industries. Also, the EEC provides technical training and advice to the ACP group.

(iii) *Stabilization of Export Earnings (STABEX):* EEC countries guarantee the stability of the earnings from the ACP exports. This covers the products, mostly raw materials, on which the ACP countries depend on, under this convention; the ACP group has more control over the EEC development Fund than before. The ACP may enter an equally favourable agreement with other industrialised or even the developing countries.

- Any ACP country may opt out of the Lome Convention if the agreement is no longer satisfactory.

Advantages of the Lome Convention

The Lome convention has the following advantages:
- ACP countries can earn more stable income from their exports of raw materials; hence they are now less vulnerable to price fluctuations.
- Countries have more access to grants and aid from the EEC.
- Any member has been given freedom to leave the Lome Convention if there is wish to do so.
- It does not promote neo-colonialism.

Achievements

Lome convention has made the following achievements:
- All ACP export of manufactured goods and agricultural products has been granted duty-free access.
- Establishment of STABEX scheme to guarantee ACP countries a specific level of income on selected commodity exports to EEC.
- To encourage industrial co-operation through the transfer of technology and encouraging of EEC private investors to establish industries in ACP countries.
- To grant ACP countries with some soft grant from EEC, through the European Development Fund and European Investment Bank.
- Attempts are being made to stabilize earnings from minerals through stabilization of export earnings from mineral products.
- ACP countries have increased in number.

Problems

Lome convention has been facing the following problems:
- Low income among the ACP countries.
- There are poor transport and communication systems in the ACP countries. There exist uneven levels of development among the member countries. This reduces effectiveness and efficiency in the operation of the Lome Convention.
- The EEC members are still rigid to allow free trade in textiles.
- There are so many political conflicts among the ACP countries, leading to less participation and contribution to the Lome Convention.
- The population in EEC is aging; hence European countries may in the long run fail to facilitate the smooth operations of the Lome Convention due to having very old people dominating the population.
- Low technology among the ACP countries.

The African Growth and Opportunity Act (AGOA)

This is the economic co-operation between the African countries and United States of America. It was promulgated in the USA and signed into law on 18th May 2000, as title one of the trades.

- The act offers tangible incentives for African countries to continue with their efforts to open their economies and build free markets.
- The government of USA announced the creation of $ 200 million over-seas private investment support facility that would give American firms access to loans guarantees and political risk insurance for investment projects in sub-Saharan Africa.
- The president of USA announced the establishment of a trade and development Agency (TDA) with its regional office in Johannesburg, South Africa, for the aim of providing guidance and assistance to the governments and companies which seek to liberalize their trade laws, improve the investment environment and take advantage of AGOA.

Achievements of AGOA

Lome convention has made the following achievements.

- During the first half of 2001, total trade between America with sub-Saharan Africa rose by almost 17%.
- The US imports from the region exceeded $ 11.5 billion.
- Some countries, such as Eritrea, Seychelles, Madagascar and Senegal, saw their exports to the USA increased by 100%.
- In Kenya, a public project, as a result of AGOA, created new 150000 jobs.
- In Lesotho, textile sectors expected to inject $122 in investment.

The World Trade Organisation (WTO)

This organisation was established in 1995 by the Marrakesh agreement. It was established mainly to over-see the implementation of all the multilateral agreements that have been negotiated in the Uruguay round and those that will be negotiated in future.

- It has over 140 member countries and accounts for over 97% of the world trade.
- Decisions are made by all the members through a consensus.
- The top decision body of WTO is the Ministerial conference which meets at least once after every two years.
- Below the Ministerial Conference is the General council, which meets several times a year at the Geneva headquarters. It is a trade policy review body, and dispute settlement body. Under the general council, there is the goods council, the services council and the intellectual property council which reports to it.
- In 1997, an agreement was reached on the area of telecommunication services, in which 69 the governments agreed to take trade liberalisation measures that went beyond those of the Uruguay round. Also, negotiations for tariffs free in information technology products were also concluded by some member countries.
- In 2001 a meeting was held in Doha Qatar in which a number of issues were discussed, including negotiations on non-agricultural tariffs, trade and environment, anti dumping, subsidies etc. The objectives of WTO are similar to those of GATT, which has ceased to exist as a separate institution and has become part of WTO. These objectives have been expanded to give WTO a mandate to deal with:-
- Trade in services.
- Protect and preserve the environment.

Functions of WTO

WTO has the following functions:

(i) To facilitate the implementation, administration and operation of Uruguay Round legal instruments and of any new agreements that may be negotiated in the future.
(ii) It provides a forum for further negotiations among the member countries on matters covered by the agreements as well as on new issues falling within its mandate.
(iii) Thirdly, it shall provide a forum for further negotiations among the member countries on matters covered by the agreements as well as on issues falling within its mandate.
(iv) It is responsible for the settlement of differences and disputes among its member countries.
(v) It is responsible for reviewing trade policies of the member countries.
(vi) It gives technical and financial assistance to developing countries.

Specialized Agencies in International Economic Co-operation

These are separate independent organisations that are related to the UNO by special agreements. Their activities are coordinated the UNO through the economic and social council

IFC

It is the International Fund/Finance for Co-operation. The fund was formed in 1956 as an affiliate of the World Bank. It promotes investments in poor countries by assisting the private sector enterprises. It has its headquarters at Washington, D.C.

IDA

It was formed in 1960 as an affiliate of the World Bank to promote economic development through long term loans for less developed countries.

GATT

This is the General Agreement on Tariffs and Trade. The GATT came forward as a result of the 1947 General Conference. It is a multi-national treaty encompassing 80% of the World Trade.

Objectives of GATT

GATT was established to achieve the following objectives:

(i) To protect the domestic infant industries, basically through tariffs.
(ii) To control the powers and activities of multi-national enterprise/ agencies/organisations.
(iii) To encourage the growth, development and more equitable distribution of gains from international trade.
(iv) To harmonize and liberalize both the tariff and non-tariff measures to negotiations.

UNCTAD

This is the United Nations Conference on Trade and Development. It was established in 1964 to handle LDCs' trade obstacles. It was a result of the unfavourable North to South co-operation.

Objectives of UNCTAD

UNCTAD was established to achieve the following objectives:

(i) To give LDCs trade (tariff) preference through encouraging and promoting both manufactured and semi-manufactured goods.

(ii) Strengthen and promote capital inflow to LDCs for development.
(iii) Promoting self-reliance and economic co-operation among the developing countries.
(iv) Above all, promoting/encouraging/stimulating economic growth and development, especially among the developing nations.
(v) To improve the terms of trade among the least developed countries by enlarging the markets for their primary products, and also stabilize prices through international commodity agreements.
(vi) The UNCTAD also aims at transfering technology rapidly to LDCs. This would encompass capacity building, research and training for LDCs in and endeavour to narrow the technological gap between the developed countries and the LDCs.

The World Bank

It is also known as IBRD, i.e. the International Bank for Reconstruction and Development. It was established in 1945 as a sister institution of the International Monetary Fund (IMF). Indeed, the IMF members are members of the World Bank. It has the USA, UK, Germany, France and Japan, as its major shareholders.

Objectives of the World Bank

The World Bank was established to achieve the following objectives:
(i) To help in the restructuring and development of the member states through genuine and adequate investment capital.
(ii) To encourage balanced growth in international trade and achieve a better B.O.P position.
(iii) The World Bank further promotes foreign investment, since private capital is often insufficient to fund productive projects.
(iv) To finance projects/programmes like roads, railways, power, telecommunications etc; aimed at improving the general welfare, especially among the poor population in LDCs.

The International Monetary Fund (IMF)

The IMF is an international financial institution which was formed after the Brettonwoods conference of 1944 and came into operation in 1947.

Objectives of the IMF

The IMF was established to achieve the following objectives:
(i) To assist member countries with severe B.O.P problems through provision of loans, technical, monetary advice and fiscal policies/ programmes.
(ii) To enhance foreign exchange stability and maintain orderly exchange programmes/policies among the member states so as to avoid the competitive foreign exchange depreciation.
(iii) To eliminate the unnecessary foreign exchange restrictions that may hamper trade among countries.
(iv) The IMF also aims at providing technical assistance by sending experts to the member countries that may need them.
(v) To promote international monetary co-operation as a basis of consultation and collaboration on international monetary programmes.
(vi) To assist in the establishment of a multi-national system of payments in respect to current transaction among the member states.
(vii) And, finally, to establish and expand a balanced growth of international trade.

The IMF structural adjustment programmes (SAP)

These SAPs include a package of IMF conditions to LDCS for them to get the IMF's assistance. These conditions include:

(i) Reduction in the government expenditure, example on the social overhead expenditure, i.e. infrastructure, health, education, social security, etc.
(ii) Devaluation. The IMF stresses that this would improve the B.O.P position of developing countries by making imports more expensive them exports.
(iii) Improvement in tax collection. The IMF urges developing countries to expand their tax base, so as to raise more revenues.
(iv) Strict monetary and credit policies. The IMF recommends credit restrictions and an increase in interest rates, so as to reduce the money supply and reduce inflation.
(v) Trade liberalization. LDCs are being forced to liberalize their markets to foreign imports through their manufactured products, because their exports are often faced with restrictions by the developed countries.
(vi) Retrenchment of workers and demobilization. The IMF also recommends reducing the number of civil servants and soldiers, though this is undertaken without proper consideration of the manpower requirements of LDCS' economies.
(vii) Wages freeze. This condition of the IMF, has, however, greatly affected the General Welfare, especially among the working class.
(viii) Privatisation and encouragement of the private sector, where economic activities are to be shifted from the state to the private sector in a bid to ensure profitability, efficiency, proper management and accountability within the private sector.
(ix) Establishment of flexible foreign exchange rate policies. In this era of globalisation, state control on economic activities has greatly been reduced. Quite often, forces of demand and supply have been allowed to prevail, hence the need for a flexible/free floating exchange rate system.
(x) In the case of LDCs, the IMF still recommends and encourages an increment production in agricultural sector.
(xi) Where the state still controls the major means of production, the IMF emphasizes efficiency in public sector enterprises.

Achievement of the International Monetary Fund

Since its establishment, the IMF has realised the following achievements:

(i) The fund has assisted the member states with balance of payments problems by finding them so as to reduce the problem.
(ii) The fund has altered its original article according to the changing international economic situation. For example. It has legalised free exchange rates, raised quotas to increase capital resources, etc
(iii) The fund has provided financial support, especially under the special import programme (SIP).This has led to an increase in varieties of commodities in the market.
(iv) The liberation policies of the IMF, especially on trade, have reduced the problems of scarcity of goods in many less developed countries.
(v) Policies, such as privatisation, have helped improve efficiency, accountability, management, and have controlled corruption.
(vi) It has increased the inflow of foreign currencies to various countries.

Failures of IMF

IMF has the following failures, despite its achievements:

(i) Controlling and restricting world trade still exists.
(ii) The funds lending rates are high and short term and indeed with high interest rates.
(iii) The IMF tends to discriminate against LDCs in favour of developed countries, who are the major shareholders.
(iv) Following the collapse of the Brettonwoods system, under which the fund was established, the IMF has failed to promote foreign exchange stability and orderly exchange among the member states.
(v) The IMF has tended to interfere with the internal economic affairs/conditions of its, member states. This is because the member countries have to fulfil the IMF conditions before getting financial assistance.
(vi) The IMF policies have widened the gap between the poor and the rich in LDCs. This is because such programmes have tended to favour the richer sections of the populations.
(vii) Standards of living have deteriorated because of the strict IMF conditions of increasing taxes, so as to widen the tax base.
(viii) Foreign exchange wastage has become a common problem in LDCs, due to the IMF's liberation conditions, which has led to the importation of unnecessary goods.
(ix) Increased debt burden has occurred in a bid to stabilize the B.O.P position as required by the IMF.
(x) Retrenchment has aggravated the problem of unemployment and this, too, has affected the people's welfare.
(xi) The IMF polices have failed to protect the peasant farmers in LDCs because of the abolition of price control programmes, e.g. the minimum price legislation.
(xii) Privatisation conditions of the IMF have greatly affected the locals, since they do not possess enough capital to purchase expensive state enterprises that have been sold off.
(xiii) Cost sharing in the education sector, as a condition of the IMF, has led to rampant school dropouts resulting in many semi-illiterates and unemployed.
(xiv) Generally, the IMF policies have proved to be unpopular. This is because the former the government’s pro-people expenditures have been stopped.

The International Children Education Fund (UNICEF)

The UNICEF was formed in December 1946 to help the governments to carry out programmes for the benefit of children and youth. For this, UNICEF has the following objectives:

(i) Gives permanent health services for mothers and children; control diseases of children e.g. malaria, T.B.; yaws, leprosy etc. Provide food programmes by feeding children, giving nutrition education etc.
(ii) Promotes child and family welfare by providing educational and vocational training for the above areas.
(iii) To give technical aid in form of tools, food, money and short and long courses, etc.

UNESCO (The UN's Educational, Scientific & Cultural Organization)
Formed on 4th November, 1946, with its headquarters in Paris.

Aims of the UNESCO
The major aim of the *UNESCO* is to contribute to peace and security in the world, by promoting international collaboration in education, science, culture and communication.

Activities of the UNESCO
(i) It expands and guides education in order to enable each country to handle its own development more effectively.
(ii) It trains teachers, educational planners and administrators, and also encourages building and equipping of schools.
(iii) It promotes the scientific management of the environment and a better use of natural resources.
(iv) It promotes the national cultural values and preserves the cultural heritage for example, by preserving cultural identities, oral traditions, writing of books etc.
(v) To survey the needs of the poor countries to be assisted, e.g. in building their own communication systems, promote teaching and learning of the social services so as to realize human rights, peace and justice for all.

The International Labour Organization (ILO)
The ILO was established in 1919 by the Versailles peace Treaty, hence associated with the League of Nations. In 1946, it was associated with the UN as a special Agency.

Aims of the ILO
- To raise the working and living standards of workers throughout the world.
- To eliminate social injustice, which leads to unrest and war.
- To advocate for full employment of workers.

Activities of ILO
- It encourages employment of workers in jobs that they fit most.
- It facilitates training and transfer of workers.
- It promotes the working conditions and ensures a fair distribution of the products of labour.
- It advocates for the rights of workers to form trade unions, and encourages workers to cooperate with their employers.
- It advocates for workers welfare health and safety at work places.
- It champions the provision of adequate nutrition, housing and recreational facilities to the workers and their families.

FAO (Food and Agricultural Organization)
Founded on 16th October, 1945, and headquartered in Rome.

Aims of the Food and Agricultural Organization
- To eliminate hunger.
- To raise the levels of nutrition and standards of living.
- To improve production, processing, marketing and distribution of food and other products from farms, fisheries and forests.
- To improve the living conditions of the rural population

Strategies of achieving its aims

(a) Promotion of:
  (i) Investment in agriculture, better soil and water.
  (ii) Investment in better crops and livestock yields, marine and inland fisheries.
  (iii) Investment in mechanization of agriculture and in development of agricultural research in the developing countries.
(b) Fighting against animal diseases that massively kill cattle, e.g. trypanosomiasis.
(c) Conservation of natural resources such as forests.
(d) Helps countries to prepare food for emergency situations and provide food relief where necessary.
(e) Improves the seed production and distribution in the developing countries

WHO (World Health Organization)

The WHO was founded on 7th April, 1947 with its headquarters in Paris, France.

Activities of the WHO (World Health Organization)

(i) To supply technical aid for fighting epidemics such as cholera, malaria, T.B. etc.
(ii) To support public health services in the developing countries by training the personnel.
(iii) To promote research on health issues such as nutrition, mother/child care, control of diseases etc.
(iv) To campaign for the immunization of 90% of all the children in the world by 2000. Diseases in target are diphtheria, measles, tetanus, T.B, whooping cough etc.
(v) To direct and co-ordinate the global campaign against AIDS-to effect prevention and control of infection.

Review Questions

1. What is regional economic integration?
2. Differentiate between regional economic integration and economic co-operation.
3. What are the advantages of economic co-operation?
4. Discuss the objectives and achievements of COMESA.
5. What is the impact of Tanzania withdrawing her membership from COMESA?
6. Examine the benefits that Tanzania gains from the East Africa co-operation
7. Explain the main problems of economic integration in Africa.
8. Discuss the main conditions for a successful economic integration.
9. Why has Tanzania not benefited much from the AGOA programme like the other member African countries?
10. Discuss the Lome convention.
11. What are the benefits that the less developed countries gain through the world trade organization?

CHAPTER SEVEN

ECONOMIC PLANNING

Introduction

Meaning of Planning
Planning is the process of organizing available resources of a country for the purpose of fulfilling certain objectives.

What is a plan?
A plan is a set of goals/ objectives that a person/ the government intend to achieve.

Planning to:

(a) *A Consumer:* Planning is the process of making decisions on how to use the available income to satisfy wants.

(b) *A producer*: Planning is process of making decision on how the available resources can be allocated to produce goods and services. It is the decision on
- What to produce
- How to produce
- For whom to produce

(c) *The government*: Planning is the conscious or deliberates the government's effort in influencing, directing and controlling economic variables. These variables are economic phenomena which affect the economy, i.e. cause economic changes. Examples of such variables are:
  (i) Investments
  (ii) Consumption
  (iii) The government expenditure
  (iv) Inflation
  (v) Population change
  (vi) Employment and unemployment
  (vii) Foreign trade (Export and Import)

Types of Economic Planning
There are two types of economic planning:

1. ***Partial Planning***

This is a type of economic planning which is based on individual sector (units) of the economy, where the government may plan to develop only one sector of the economy. An example of such a plan is the basic industrialization program of 1975-2000, which was a plan intended for developing industrial sector in the covering period.

2. ***Comprehensive Planning***

It is a type of planning in which all sectors of the economy are taken into consideration and it is made by the central the government to meet the needs of the whole country. An example of a comprehensive planning is the national annual budget. The comprehensive planning has the following three periods:

(a) *Short Term Plan:* This takes six months up to two years for the objectives of the plan to be implemented or achieved. An example of such a plan, Tanzania is the national budget in.
(b) *Medium Term Plan:* This takes a duration of 2 to 7 years for the objectives to be achieved. Example of such a plan was the *Ujamaa* (socialism) of 1972 and agriculture for life and death.
(c) *Long Term Plan:* This takes a long period of time for the objectives to be implemented and achieved. It takes a period of 15 to 20 years. Example of such a plan is the basic industrialization strategy.

Features of an Economic Plan

An Economic plan has the following features:

1. ***It covers a Certain Period***

An Economic plan must have a time limit in which the intended objectives should be covered. For example, two years, five years, etc.

2. ***It Addresses a Particular Issue or Problem***

An economic plan must show which issue or problem it deals with, e.g. a plan to promote industrial development; a plan to promote rural development; or a plan to control economic problems like inflation, unemployment, etc.

3. ***Consistency and Coordination***

Various economic plans in different sectors need to be coordinated in order to ensure growth of all sectors of the economy and smooth implementation of the plans, i.e. there must be a backward and forward linkage between agricultural and industrial sectors, and plans must be consistent with the prevailing situation and aim at implementing what is intended in the plan. For example, a plan to develop the industrial sector must be made if there is availability of funds to develop the sector, and such funds must be used for developing industries and not otherwise.

4. ***Plan Evaluation or Appraisal***

This is the process of assessing the costs and benefit of projects in a certain plan. It examines the suitability of the projects to the society and the social costs that may occur. Under such a situation, the decision will be based on the merits of the project.

5. ***Policies and Strategy***

Policies are statements indicating the type of economy that a nation wants to build. They act as guidelines for the implementation of a particular plan. For example, a plan to develop industries must have various policies which will help implement the plan, such as import control policy; to control importation of goods from abroad can be used to protect the domestic industries and tax relief policy; to encourage investments in the sector. Also, a plan must have strategies to assist its implementation. Strategies are statements indicating how the policies will be implemented. For example, in the *Ujamaa* socialism policy, various strategies were used, these include:
(a) Use of force to make people adopt the policy.
(b) Education to the people.
(c) Provision of various incentives to those who were ready to live in the *Ujamaa* villages

6. *A plan must have Goals*

An economic plan must state what it intends to do and achieve. A goal is the target that a plan is directed towards, example of such targets are;

- To promote growth of the national income
- To create employment
- To promote development of other sectors
- To reduce dependency, etc.

7. *Planning Machinery*

This is the government's ministry or department which coordinate various plans from different sectors and lays down the plans for the whole country/economy. For example, in the basic industrialization, the planning machinery was the ministry of industry and planning.

8. *A Plan is a Social National Institutional Process*

A plan is said to be social in the sense that its formulation involves people and it's made for the people. A plan is intended to achieve specific objectives for the benefits of people. It's a rational institutional process, meaning that a plan is made by a certain institution that is responsible for the formulation of the plan, which follows the objectives and principles that are consistent with the needs of the society

Economic Planning in Different Economic Systems

(a) *In Capitalist Economy*

In capitalist economy, there is no central planning, price mechanism takes charge of all the major economic decisions of what to produce, how to produce, for whom to produce, where to produce, when to produce, etc. In this system, partial planning, i.e. planning by individual units of firms or consumers is the most dominant type of planning. Individual entrepreneurs plan for their firms. The role of the government is only to provide a conducive environment or indication to the private sector, but not ready made decisions of what the individuals are supposed to do in the course of running their firms. Instead, the government is concerned with other functions such as protections of the state, law and order, and ruling its citizens.

(b) *In Socialist Countries*

In socialist countries, there is a central planning. The government is involved in formulation and implementation of various economic plans on behalf of its citizens. All plans in socialist countries are comprehensive, i.e. they cover the whole nation. The aim of the government is to:

- Raise the welfare of its citizens
- Raise the national income.
- Remove income inequalities, etc.

(c) *In Mixed Economy*

In mixed economic system, both the government and price mechanism are involved in making decisions. The government plans allocation of resources in some areas, while the individuals also make decision for their individual firms.

Advantages of Economic Planning

Economic planning provides the following advantages:

(i) Planning prevents misuse of resources, by ensuring that resources are allocated in the most productive sectors of the economy, and avoids allocating resources in non productive sectors.

(ii) Planning ensures that scarce resources are used in the best way possible, i.e. optimal way.

(iii) Planning is necessary for equitable distribution of wealth. It helps to allocate resources in the society in such a manner that it maintains equality of income among the people. For example, the government can decentralize allocation of industries in order to create equality in development among the regions in the country.

(iv) Planning is a powerful instrument of maintaining economic stability of the country. Through planning, the government controls economic problems such as inflation, unemployment, low growth of the national income, etc.

(v) Planning eliminates wasteful competition among the producers, which often leads to over production, fall in prices and wastage of resources

(vi) Planning may lead to rapid growth of capital accumulation. Without planning, capital goods may grow at a slow rate, because private investors become less interested in developing the capital goods. This is because capital goods have a slower rate of returns than consumer goods.

(vii) Planning is a good instrument through which welfare goods (public goods) can be well provided, than if the supply of these goods is determined through price mechanisms. This is because most public goods such as education, health, defence and security are very difficult to be charged with a certain price, and they are consumed by the majority of the citizen. In this case, private enterprises cannot efficiently provide public goods.

(viii) Planning can be used as an instrument of soliciting (seeking) for foreign aid. Most of the donor countries/institutions would like to know the plan of the recipient country with indications of the needs of the country, the targets/goals, how the plan is to be implemented and how the funds are to be used.

(ix) Planning is a powerful instrument of controlling standards and quality of goods and services that are produced in the country. Through planning, the government can fix certain standards of goods/ services that every producer is supposed to meet in order to protect the welfare of its citizen.

(x) Planning is helpful in controlling negative externalities, i.e. the side effects of any production activities. Examples of externalities are; environment pollution and accidents. For example, by planning to build industries in non- residential areas, the government is able to protect the citizens from the problem of noise and air pollution.

Disadvantages of Economic Planning

Economic planning has the following disadvantages:

(i) Planning interferes with the free allocation of resources by the owners of the factors of production. Because, under the planning system, the government decides what to produce, how to produce and for whom to produce. Due to this, private incentives and initiatives are discouraged.

(ii) Under the planning system, consumers' freedom of choice is very limited. Because the government determines what should be produced and what should be consumed.

(iii) A lot of resources are used by the government officials in the process of planning. Thus, planning increases burden to the government.

(iv) The government officials are involved in the planning process. The use of such officials leads to bureaucracy in decision making, and therefore delays in reaching at various decisions.

(v) Planning involves the government officials in the control of resources such a control, under some circumstances, may leads to corruption, whereby the government officials misuse the public resources for private benefits and not for public interests.

(vi) Planning may sometimes misallocate resources in the following ways:
- When resources are allocated in non-productive sectors such as buying of arms.
- Establishment of certain social services for the purpose of gaining political popularity.
- Establishing a certain project or service where it is least demanded.

(vii) Planning discourages competition among the producers and the suppliers of services. This leads to inefficiency in production and provision of services and emergence of monopoly the government enterprises which are usually inefficient.

(viii) Some the government plans fail due to the lack of resources for implementing such plans and poor planning skills. This causes wastage of resources.

(ix) Many plans cannot foresee the future socio-economic changes because they take a very long period of time to be implemented; as a result, they fail.

Problems of economic planning

Economic planning encounters the following problems:

(i) *Lack of information:* In many countries, especially the less developed countries, there is no reliable and accurate information on various socio-economic variables such as population, the national income statistics, the government budgets, etc. Therefore, it becomes very difficult for the planners to make proper plans for such countries.

(ii) *Lack of trained personnel in planning:* The planning process requires people with skills in the formulation and implementation of plans. In most of the less developed countries, there is lack of trained personnel in the field of planning. Therefore, most of the plans are not well prepared, hence fail to be implemented.

(iii) *Existence of a large private sector:* The existence of larger and strong private sectors in the economy may harm some of the government plans. The private sectors may sometimes not be willing to cooperate with the government in implementing the government plans.

(iv) *Foreign intervention:* Planning, in less developed countries like Tanzania, is affected by the interference from outside the country, especially from donor countries and international financial institution. Therefore, the planners in the LDC's are forced to implement ready made plans from the donor countries in order to meet the conditions of getting financial aid. These plans, from the donors, sometimes may not serve the country's interests; rather serve the interest of donors themselves.

(v) *Political interference:* Politicians often uses planning as a tool of achieving their political objectives, such as winning elections and increasing their popularity in their constituencies. They sometimes manipulate resources, which were intended for some development projects, to fund their political activities in order to please the voters.

(vi) *Dependency on foreign aid:* Most of the plans made in the LDC's depend on foreign aid. These aids are very difficult to get, and when granted it is usually attached with some

conditions and, in most cases, it does not come on time. This affects the planning process and delays the implementation of plans.

(vii) *Lack of commitment in implementation:* For plans to be successful in their implementation, all the effectors, in the process of implementation, must be full committed to the implementation of the plans. However, most plans fail because some effectors are not committed to implement what is supposed to be implemented in the plans.

(viii) *Shortage of planning machinery:* The government plan must have planning machinery, the i.e. the government's ministry or department which is involved in formulation and implementation of plans. However, in some countries like Tanzania, there are no enough, government departments for the implementation of different plans.

(ix) *Lack of funds:* Planning is affected by the lack of funds for buying different resources that are important for the establishment of projects of a plan.

(x) *Lack of policies to support plans:* Any plan must be accompanied by some policies that support the plan. For example, a plan for industrialization must have some protectionism policies which promote and protect domestic industries. Without such policies, the plan for industrialization may fail because the local industries would be affected by cheap imports.

Conditions necessary for a successful planning process

The conditions that are necessary for a planning process to be successful include:

(i) There must be accurate and reliable data.
(ii) The coverage of the plan must be known; whether partial or comprehensive.
(iii) There must be political commitment and will to implement the plan.
(iv) Political stability.
(v) Evaluation of the plan, i.e. there must be some assessment on whether the plan is successful or not.
(vi) Planning machinery. For planning to be successful, there must be some institutions to implement the plans
(vii) Time period. The period in which the plan will achieve its objectives must be clearly stated. For example, two years, three years, four years etc.
(viii) Resource identification. A good plan must indicate the resources to be used, and how the resources should be mobilised for use.
(ix) Feasibility of the plan. Planners must ensure that what is planned in different projects can be achieved in a given period of time, and there are enough resources to implement the plans.

Tanzania's development plans

Since independence, the government of Tanzania has been formulating various development plans, one of the plans is, *Five year development plan (1964-1969).*

Background to this Plan

At the attainment of independence, the government of Tanganyika was aware of the problems which were facing the country, as a result of that, in March 1963; a new ministry of development planning was formed. International experts from France were recruited to study the problem and come up with a realistic method by which they could be tackled. These experts came with the following conclusions.

- Income per capita was very low.

- Poverty of the country results more from structural deficiencies in the economic and social fields than from real lack of potential within either of them.
- In order for the national effort to be purposely directed, it is clear that logical planning is necessary. As a result of the study, the government, through the by then president of the country, Julius Nyerere, announced the new five-year development plan in May 1964.
- The plan was to cover the period between 1964 and 1969, although it looked as far as 1980 by its long term effects.
- The plan was to cost 246 million pounds.

Aims of the five year development plan

The five year development plan had the following aims:

- To raise the annual per capita income of the country to 45 pounds, by 1980, from its current, estimated at 19 pounds.
- To increase the GDP growth by 6.7% per annum.
- To have fully qualified Tanzanians to fill the entire skilled professional and management jobs by 1980, instead of relying on expatriates as at present.
- To increase the life span of the population from between 35 to 40 years up to 50years by 1980. To have a population of 18 million by the same year.
- To establish primary processing industries which would raise the value of Tanzania's exports and would at the same time render them less sensitive to price fluctuations.
- To increase the growth of the manufacturing sectors to 15% by 1970.
- To reduce the subsistence primary production from 60% of the GDP in 1960-2, to 39% by 1980.

Outcomes of the Plan

The five year development plan had the following outcomes.

- The GDP grew by only 5% per annum, compared to the 6.7% which was targeted.
- Total employment of agricultural wage employment, such as in the sisal industry, fell by 5.4%, due to drought and fall in the price of exports.
- Employment in manufacturing and public services increased.
- Average wages in the private sector increased by 16.7% in 1965.
- Production in industries increased by 11%.
- By the years between 1963 and 1965, the private sector investment increased from 13.9 million pounds to 23.7 million pounds, while the public sector investment increased from 10.3 million pounds to 13.7 million pounds.
- By the mid 1967, the expenditures by ministries on development amounted to 24.7 million pounds.
- Reduction in the relative size of the subsistence sector from about one third $\left(\frac{1}{3}\right)$ of the GDP, in 1960-2, to only 14% by 1980.

Bottlenecks to the Plan

The five year development plan faced the following obstacles:

(i) *Factors outside the control of the planners:* There were external economic factors outside the control of the national planners. For example, in 1964-5, the expected growth in

exports earnings was retarded by a fall in the prices of major exports such as cotton, coffee and sisal, and by drought, which affected the volume of output.

(ii) *Low inflow of expected foreign investments:* The inflow of private investment capital and official aid from overseas failed to match its planned contribution to the total capital formation. It was anticipated in the plan that about 80% of Tanzania's central the government and the government enterprises investment was to be financed by funds from abroad, and only over half of the country's total investment be financed from overseas. This was too much optimism, since, in the long run, only 25% rather than 50% were financed from abroad.

(iii) *Communication lag:* There was a gap in communication between the planners who produced the plan document, and the officials who were in of the implementation of the plan and the other people who participated in it.

(iv) *Departure of its planning experts:* The plan was made by a team of French planners who departed before the full implementation of the plan; this caused some problems in its implementation.

(v) *Withdrawal of assistance from Germany and Britain:* Following Tanzania's political disputes with Germany and Britain, these two countries withdrew their technical and financial support to Tanzania, as a result, most plans failed to be implemented due to lack of support.

(vi) *Shortage of skilled and technical manpower:* There were shortages of skilled and technical manpower to monitor the implementation of the plan.

(vii) *Over and under allocation of resources in some projects:* There was misuse of resources, since resources were over allocated in some less important projects, while in other important projects, resources were under allocated. This problem was caused by lack of precise information on the preparatory stage of the projects and their phasing.

Review Questions

1. What is economic planning?
2. Describe the main features of economic planning.
3. "Planning is wastage of resources". Discuss.
4. Explain the main advantages and disadvantages of economic planning.
5. What are the problems of economic planning?
6. What is comprehensive planning?
7. Why do most plans in the LDC's fail?
8. What is indicative planning?
9. Discuss the necessary conditions for planning.
10. "Planning is a social rational process". Discuss.
11. Discuss the five year development plan between 1964 and 1969.

CHAPTER EIGHT

ECONOMIC STRUCTURE OF TANZANIA

Meaning of Economic Structure

Economic structure is the way various sectors of the economy are organised in terms of their roles, ownership and set up. Economic structure indicates the framework of economic units that compose the economy.

Aspects of Economic Structure

There are two aspects of economic structure - *Sectoral pattern* and *Ownership pattern.*

Sectoral Pattern

The sectoral pattern shows various sectors which make up an economy. In Tanzania, there are following three main sectors of the economy:

A. Agricultural sector (primary sector)
B. Industrial sector (secondary sector).
C. Tertiary sector (commercial and service sector)

A: Agricultural Sector (Primary Sector)

It is the sector which involves farming and other activities that produce raw materials such as mining and fishing. In Tanzania, about 80% of the people are employed in this sector. The sector contributes to about 60% of the country's Gross domestic product.

Evolution of Agriculture in Tanzania

1. Before Colonialism

- Before the coming of the colonialists, agriculture in the country involved mainly food production, and it was at subsistence level due to the low population and the poor technology used.
- There was no surplus of the products produced.

2. During Colonialism

During colonialism, the nature of agriculture changed.

- Colonialists put more emphasis on the production of cash crops, such as coffee and cotton, than on food crops.
- Colonial agriculture was forceful in nature; Africans were forced to grow cash crops and alienate their fertile soil.
- To ensure a constant supply of labour, the colonialists introduced tax, forced labour, the migrant labour system and the land alienation policy.

3. After Independence

After independence, the government of Tanzania took the following steps to boost the agricultural sector:

- Emphasis was put on both cash and food crops.
- Introduction of *Ujamaa villages* in 1974.
- -Establishment of state farms.
- Establishment of the co-operative and rural development bank to assist the farmers and co-operative societies.

- Provision of subsidies to the peasants.
- Introduction of agricultural extension officers.
- Nationalisation of plantations that were owned by the white farmers before the independence.

Roles of Agriculture in the Tanzania's Economy

Agricultural sector plays the following key roles in the Tanzania's economy:

- It supplies food to the country's population.
- It provides raw materials to the industrial sector.
- It provides employment and income to majority of the Tanzanians.
- It is the main source of the national income; about 60% of the GDP come from the sector.
- It is the main source of foreign earnings.
- It promotes other sectors of the economy such as trade and industry.
- It provides revenues to the government in form of tax.

Problems Facing the Agricultural Sector in Tanzania

Tanzania's agricultural sector faces the following problems:

(i) Unfavourable climate/unreliable weather e.g. unreliability rainfall.
(ii) Shortage of capital to buy the farm implements. This forces the farmers/peasants to use poor farm implements such as the hand hoes.
(iii) Dependence on nature in the cultivation of crops; a larger percentage of agriculture in the country depends on rainfall and very few people apply irrigation. Also the output depends on the natural fertility of the soil, not on the modern methods of farming.
(iv) Lack of storage facilities, as a result, many crops get destroyed after harvesting.
(v) Poor marketing arrangements, as a result, farmers sell their crops on credit at very low prices.
(vi) Pests and diseases which affect the crops.
(vii) High cost of the inputs, such as fertilizers, due to the withdrawal of the government's subsidies and currency devaluation.
(viii) Poor infrastructure, like the transportation and communication system. This hinders the transfer of crops from where they are produced, to the areas where they are demanded.
(ix) Calamities brought by natural catastrophe such as droughts and floods.
(x) Price fluctuation in the world market.
(xi) The problem of rural to urban migration, which reduces the labour force that is necessary for employment in the agricultural sector in the rural area.

Fluctuations in the Price of Agricultural Products

Price fluctuations are changes in the prices in form of "ups" and "downs" over a period of time as a result of the changes in demand and supply. The prices of agricultural products are unstable; they fluctuate more widely than the prices of industrial products. This is one of the problems facing developing countries, since agriculture is the *'back-bone'* of such countries.

Causes of Fluctuations in Price of Agricultural Products

(i) Natural factors such as weather, pests and diseases may reduce the volume of output. With favourable natural conditions, output increases, leading to a fall in the prices. Unfavourable natural factors lead to a fall in output and, hence an increase in prices.

(ii) Agricultural products are perishable: Therefore, they should be sold immediately after harvest and, consequently, this leads to a fall in their prices. Before harvest, the supply is so small such that the prices shoot up.

(iii) Agricultural products are sometimes inputs. They, therefore, form a very small part of the total cost of production, e.g. rubber in the case of car production.

(iv) Inadequate storage facilities for some agricultural products prompt farmers to supply more, thereby, leading to a fall in prices.

(v) Gestation period: Once a given amount is planted, it is quite difficult to increase the supply. The price, within a short run, will tend to rise. In the long run, the price will tend to fall; since the amount supplied shall have increased.

(vi) Overproduction: As more agricultural products flood the market, their prices will tend to drop.

(vii) Agricultural products, being raw materials, sometimes experience derived demand. Changes in the prices of the final products made from the agricultural raw materials may, too, cause changes in their prices.

(viii) Most agricultural products are quite bulky: This makes it difficult to transport them, from places where they are cheap and plenty, to areas where they are expensive and scarce.

(ix) The demand for foodstuffs is inelastic: When consumption is at its saturation point, no more can be consumed even if the price is very low, or even when the consumers' income increases.

(x) Competition from artificial fibres from developed countries. For example, cotton and sisal competing against synthetics, has greatly affected the prices of agricultural products from developing countries.

(xi) Farmers' ignorance: Planning amongst farmers is poor because they seem to be ignorant about the relationship between output, gestation period and the level of prices.

(xii) Pricing of certain agricultural products is made difficult further due to failure by the farmers in assessing their values in terms of the costs of production involved.

(xiii) Fluctuations in the prices of agricultural products may also be attributed to the practice of stock-piling by big consumer countries, especially when the prices are low.

(xiv) The weak bargaining power of the producer countries, for their products, also leads to price fluctuations.

(xv) The limited levels of diversification, because of the tendency to over specialize in certain crops, too, lead to fluctuation in the prices of certain agricultural products.

(xvi) Poor Terms of Trade (T.O.T) of the poor countries whose economies basically depend on agriculture.

(xvii) Weak international commodity agreements that have, at times, failed to regulate quotas and the prices of agricultural products from the member countries.

(xviii) Inadequate stabilization fund to regulate the prices when the price of an international commodity fluctuates.

(xix) Limited state involvement as a result of the current era of privatisation, in which a lot of freedom is given to the private sectors to estimate the prices at which they sell their products.
(xx) Changes in the cost of production: When production cost increases, the prices of agricultural products, too, will rise and vice-versa.
(xxi) Technological advancement of the developed nations: Where agricultural products form the basic raw materials, techniques of savings the raw materials have been developed, e.g. recycling of used products.
(xxii) The low income elasticity of demand for the agricultural products.

Effects of Price Fluctuations in the Price of Agricultural Products

When the prices of agricultural products fluctuate, it may they lead to the following impacts:

(i) Fluctuating the government revenues: Revenues for the government are likely to fluctuate, especially the export earnings.
(ii) Price fluctuation makes it difficult for the government to plan adequately, due to unpredictable financial flows.
(iii) Agricultural producers may be discouraged due to the uncertainties arising from the fluctuations due to the instabilities in the prices.
(iv) Agriculture, being a major employing sector, the levels of employment will tend to fluctuate due to the instabilities in the price.
(v) Unfavourable terms of trade are likely to be experienced, since export prices tend to fall below the import prices.
(vi) As the price of agricultural products fluctuates, so is the income of those engaged in the sector.
(vii) Price fluctuations in the economy may cause a country to over depend on foreign aid.
(viii) Balance of payments problems can occur in case the foreign exchange expenditures exceed the foreign exchange revenues.
(ix) The level of imports will be greatly affected due to uncertainties in acquiring adequate foreign exchange to finance them.
(x) Uncertain and unpredictable foreign exchange earnings.

Strategies for Improving the Agricultural Sector in Tanzania

The Strategies for Improving the Agricultural Sector in Tanzania include the following:

(i) Improvement of infrastructure, such as transport and communication, in order to facilitate marketing of the agricultural products and the transportation of inputs.
(ii) Establishment of irrigation schemes in order to ensure a continuous cultivation of crops throughout the year.
(iii) Encourage the use of organic fertilizers rather than inorganic fertilizers because organic fertilizers are cheap and friendly to the soil.
(iv) Provision of credits and subsidies to peasants to enable them buy inputs such as tractors, fertilizers, pesticides etc.
(v) Mechanization of agriculture in order to increase the land under cultivation and improve the efficiency in production of agricultural products.
(vi) Control the prices of agricultural prices in order to eliminate fluctuations in prices.
(vii) Provision of education and training to peasants on the modern methods of agriculture.

Roles of the Agricultural Sector in the Development of the Industrial Sector

The Agricultural sector plays the following key roles in the development of the industrial sector.

(i) It supplies input to the industrial sector in form of raw materials such as cotton.
(ii) It provides market for the industrial products such as fertilizers.
(iii) It is a good source of capital accumulation which can be used to develop the industrial sector.
(iv) It provides food to the industrial workers.
(v) It provides a reserve team of labour that can be employed by the industrial sector any time when demanded.

Improvement and Transformation Approach in Agriculture

Improvement approach in agriculture is to make changes within the same framework of small scale peasantry agriculture. It aims at improving production by supporting the small scale peasantry agriculture.

Improvement agriculture adopts the following ways of improving production of peasantry agriculture:

- Encourage the use of labour saving devices such as plough
- Provision of credits and subsidies to the peasants
- Provision of incentives to the peasants
- Research on better seeds
- Biological innovations in agriculture, such as the use of manure

Transformation approach is the approach intended to modernize agriculture and transform it to large scale production by applying modern technology in agriculture. Transformation approach is based on the argument that the traditional tools of agricultural production, such as hand hoes and pangas, are the hindrances towards revolution in agriculture, and that they contribute to the low income of the peasants, thus causing vicious cycle of poverty.

Transformation approach suggests the following measures for modernizing and transforming agriculture:

- Encourage the use of motorized machines, such as tractors in agriculture.
- Irrigation schemes
- Settlement schemes
- Ranching

B. Industrial Sector or Secondary Sector

This is mainly concerned with processing of raw materials into finished goods. In Tanzania, the industrial sector accounts for about 10% of the total employment and about 20% of the GDP.

Tanzania has the following types of industries:

(i) Processing industries.
(ii) Manufacturing industries.
(iii) Consumer goods industries.
(iv) Assembling industries.

The Nature of Industries during the Colonial Period

During this period, the colonialist established industries for consumer goods, such as cigarettes, biscuits, meat packing, etc, and semi processing industries in order to reduce bulkiness of raw materials. Colonialists imported manufactured goods to replace the locally produced goods.

Industries after Independence

After independence Tanzania introduced the following policies for the purpose of promoting the industrial sector:
(a) Import-substitution industrialization strategy (1961-1975)
(b) Basic industrialization strategy (1975-1995)

Import-substitution Industrialization Strategy

This was a strategy in which formerly imported goods started being produced domestically by the country's industries.

Advantages of Import Substitution Industrialization strategy

Import substitution industrialization has the following advantages:
(i) It can help to reduce deficit balance of payment because it reduces imports.
(ii) It helps to save foreign currency, which was formerly used to import goods from abroad.
(iii) It generates foreign currency through exports.
(iv) It creates markets for the domestically produced raw materials.
(v) They provide important/necessary equipment to other sectors of the economy, such as hand hoes for the agriculture sector.
(vi) The programme saves the country's foreign exchange expenditures, since it tends to reduce the expenditures on imports.
(vii) Creation of employment. As domestic industrial production expands, more job opportunities are also created for the natives.
(viii) Reduction of dependence. Import substitution reduces dependence on imported goods, thereby promoting the spirit of self-reliance.
(ix) Increased levels of production. High levels of domestic production lead to the expansion of the national output, hence results into economic growth.
(x) Infrastructure development. Import substitution programmes are likely to promote and encourage the development of infrastructure in the country.
(xi) Domestic resource utilization. The strategy encourages the exploitation and use of the available domestic resources.
(xii) Reduction in BOP deficit. Import substitution strategy is quite instrumental in checking the Balance of Payments (BOP) deficits, as it minimizes the country's foreign exchange expenditures.
(xiii) Skill development. The policy is vital in the development of the domestic skills, which are important for production purposes.
(xiv) Economies of scale. Increased investment in the country (both foreign and domestic) expands the level of production, and improves economies of scale.
(xv) Forward and backward linkages. Import substitution encourages inter-complementarities in production, thereby creating both forward and backward linkages.

(xvi) Improvement in economic welfare. The strategy widens the scope of production and the availability of goods and services at home. It will, consequently, increase a wide variety of choice, so as to improve people's standards of living.

(xvii) Controlling imported inflation. By minimizing the volume of imports, the import substitution industrial development strategy may greatly check the problem of imported inflation.

(xviii) Reduction of dumping practices. The strategy aims at producing high levels of output for the domestic market. This tends to minimize the dumping of cheap imported goods into the country.

(xix) Industrialization. Import substitution is vital in the speeding up of the country's industrialization process.

Disadvantages/demerits of import substitution

(i) In the poor countries, there is limited domestic consumer market due to the prevalent low levels of income and the low purchasing power. Some products may remain unsold; thereby leading to wastage of the resources invested in import substitution industries.

(ii) Import substitution requires a lot of protection and subsidies from the government; something that most government of the less developed countries cannot afford.

(iii) Some Import substitution industries require importation of machinery, raw materials, capital equipment, etc, from abroad, which may lead to balance of payments problem.

(iv) In the short run, import substitution strategy limits the country's export potential as it concentrates on the production of goods to satisfy the domestic market.

(v) Most of the goods that are produced by these industries are of poor quality due to the poor techniques of production.

(vi) Imported inflation is often encouraged by the need to import the required capital inputs for the industrialization substitution strategy. In addition, this increases the foreign expenditures of the country.

(vii) In the short run, import substitution industrial strategy limits the country's export potential, as it concentrates on the production for the domestic consumption.

(viii) There is no doubt that some of these industries are often characterised by inefficiency, which retards the economic growth.

(ix) Poor quality products. In the LDCs, the import substitution industrial strategy may be good, but their products seem to remain poor in terms of quality.

(x) Such industries are usually urban-based due to market pull and other factors. This leads to rural to urban migration.

(xi) The decrease or abolition of duties on imported raw materials and other intermediate goods so as to reduce the cost of production for these industries reduces the government revenues.

(xii) In the poor countries, the products of the import substitution industries have insufficient market due to the desire, among the natives, to consume imported goods.

(xiii) The import substitution industries tend to concentrate on the production of consumer goods instead of capital assets. This limits the rate of investment for the future.

(xiv) The strategy requires a lot in terms of manpower. Implies training of labour abroad, which may necessitate a lot of expenses to the country.

(xv) The import substitution industries may emerge as monopolies, due to high levels of protection and lack of competition.
(xvi) In the poor countries, there is a common problem of inadequate capital. This will definitely hinder the growth and the expansion of the import substitution industries.
(xvii) Import substitution industries tend to encourage foreign investments. However, this has often resulted into profit repatriation.
(xviii) Production of luxury items. The strategy may lead to the production of luxury goods, if it is to satisfy the already existing domestic consumer market.
(xix) There is need to provide a peaceful political atmosphere, fiscal and other incentives, if foreign investors have to be attracted. This may prove difficult to the LDCs.

Basic Industrialization Strategy

This was adopted in 1975 in order to produce intermediate goods capital goods. Examples, in Tanzania, of industries established under this strategy are Ubungo Farm Implement (UFI) ZZK Mbeya, Kilimanjaro Machine Tools Mang'ura etc. These industries succeeded to produce various equipments such as farm implements and spare parts. However, these industries failed to achieve their objectives because of a number of reasons, such as lack of capital, high cost of production, small size of the market etc.

Small Scale Industries Programme

Small scale industries, in Tanzania, were introduced in 1973. These industries were expected to use low initial capital and low technology, especially indigenous technology, depending on locally produced materials.

Roles of Small-scale Industries

Small-scale industries play the following roles in the economy:
(i) They offer market for the domestically produced raw materials.
(ii) Provide employment to the nature people
(iii) They provide forex by the way of exports
(iv) They provide grounds for future investment in heavy industries.
(v) They provide goods and services that are needed in the society.

Problems of Small-scale Industries

Small-scale industries face the following problems:
(i) They produce poor quality of goods due to low technology.
(ii) Lack of effective demand due to problem of income which most of the citizens face
(iii) Lack of proper infrastructure such as electricity, roads, water etc
(iv) Competition with large scale industries within and outside the country
(v) Lack of the capital that is necessary for buying inputs.

The Roles of Industrial Sector in the Economy of Tanzania

Industrial sector play the following roles in the economy:
(i) They provide employment to the people; about 10% of the people are employed in this sector.
(ii) It generates the national income; about 20% of the GDP comes from the industrial sector.
(iii) It is one of the sources of foreign currency.
(iv) It improves infrastructure in the areas where industries have been established.

(v) Creates market for the agricultural sector because it was agricultural products as raw materials
(vi) Provides a range of commodities to meet the needs of the consumers.

Roles of the Industrial Sector in the Growth of the Agricultural Sector

Industrial sector plays the following roles in the growth of the agricultural sector:
(i) It provides market for the agricultural products which are used as raw-materials.
(ii) It provides agricultural inputs such as fertilizers, hoes, tractors etc.
(iii) It adds value to the agricultural products.
(iv) It provides income to the people, which can be used to purchase agricultural products
(v) It stabilizes prices of agricultural products

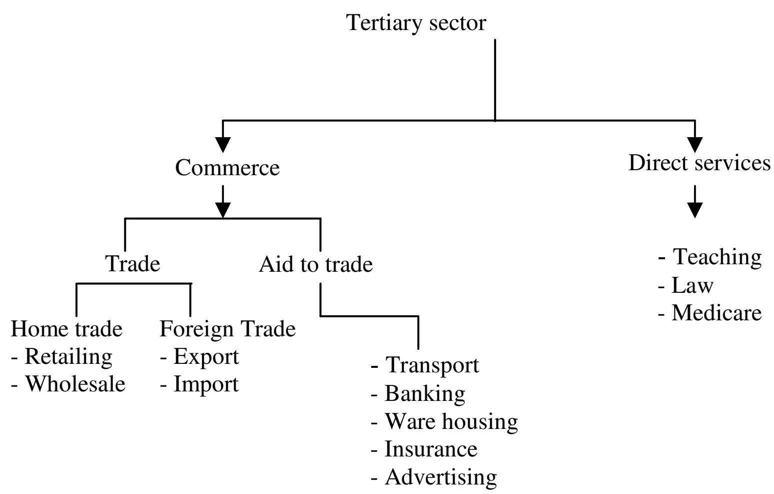
Problems Facing the Industrial Sector in Tanzania

The industrial sector in Tanzania faces a number of problems which includes the following:
(i) Poor management; people entrusted to run the public industries fail to perform their function such as planning, making research etc
(ii) Lack of capital for buying inputs and employing skilled and unskilled labour
(iii) Weak domestic markets and foreign markets, due to the low income of the people, and competition with products from outside the country.
(iv) Problems of infrastructure such as roads, electricity water etc.
(v) Location of industries in which some have been located away from the sources of raw materials, market centres and skilled labour. This increases the cost of production and transportation.
(vi) Lack of technology forces domestic industries to use a lot of forex to import technology from outside the country. This may result to production of goods of low quality, which ultimately fail to get market within and outside the country.
(vii) Low productivity of labour due to various reasons such as low wages, poor working conditions, lack of security, poor incentives, low level of education etc.

C. Tertiary Sector

This involves trade, aid to trade and direct services.

Summary of the structure of the tertiary sector



Roles of the Tertiary Sector in the Economy of Tanzania

Tertiary sector in Tanzania play the following roles:

(i) It ensures constant supply of goods and services to the people in form of trade.
(ii) It provides employment provision to the people.
(iii) It provides income in form of profit and wages.
(iv) It creates a conducive environment for investment to take place for example, banks provide loans, insurances protect investments against risk or loss, etc.
(v) It helps to stimulate production by bridging the gap between the producers and consumers through transportation and communication.
(vi) The tertiary sector stimulates other sectors such as the agricultural sector and the industrial sector, because it enhances the transfer of goods, from the areas where they are produced to the areas where they are demanded for consumption.
(vii) Direct services, such as teaching and training, provide skills and knowledge to the population, which increases efficiency of labour. Some direct services, like medical care, are necessary for creating a healthy labour force. Direct services, like law and police, maintain peace and security, which are important protections of investments.

Ownership Pattern of Tanzania Economy

This refers to the ownership of the major means of production, that is, capital, labour, land and entrepreneurship. It means who owns major means of production. The ownership of the economy, in Tanzania, is divided into the following three sectors:

(a) Public sector ownership
(b) Private sector ownership
(c) Co-operative sector ownership

Background of Ownership Pattern in Tanzania

Pre Colonial Period

Before the coming of the colonialist the major means of production were owned communally.

Colonial Period

During the colonial period, the major means of production were owned by individuals or private ownership

After Independence

After independence, the ownership of the major means of production continued to be in the hands of a few individuals up to 1967, when the Arusha Declaration was introduced. The declaration transferred the ownership from the private sector to the public sector.

(a) Public Sector Ownership

This is the type of ownership whereby the major means of production are owned by the government. In Tanzania, public ownership begun in 1967, as a result of the Arusha Declaration.

Why the Public Sector?

It is often argued that business ownership should be left to the general public, and the state should not complete with individuals. However, the public sector ownership is justified by the following reasons.

(i) Certain units provide essential services, and if these were left to private enterprise, the public might be exploited. For example, electricity and water which are essential

both for household and industrial consumption, if the electricity company was owned by private individuals, they would certainly charge so high to make the maximum possible profit without considering the hardship that might be experienced by the general public in the absence of electricity. Also, a profit motivated electricity company would provide services in only those areas that are likely to generate good revenue, hence ignoring the rural areas, thus hindering the overall development of the country.

(ii) Certain services are unprofitable, though essential for the general well-being of the people. The private sector will not want to engage in activities which do not show a good return on capital, for example, the railway corporations in East Africa.

(iii) Certain types of establishment require a great deal of initial capital outlay. The private sectors, particularly in developing countries, are unable to raise that much money. An example is the airways. Even if the private sector or a few individuals are able to raise that much money, they may not be willing to put it in one establishment, due to the risks involved.

(iv) Since the government does not aim at making profit from its activities, essential commodities such as water and electricity may be provided to consumers at a cheaper rate. Even when a public corporation does make a profit, such profits go to the government and are then spent for the benefit of the whole country.

(v) Certain activities like atomic energy are too risky to be left in the hands of the private sector.

(vi) Often, the government establishments enjoy a monopoly in their relevant field, e.g. there is no company competing with the Tanzania electricity Supply Company (TANESCO). This means the scale of production, economies of scale, can be reaped.

(vii) It is not always practical to have competition, for example, with railways. When it is possible for one company to provide the service to the whole country, it is much better that such a company be the government-owned than private owned.

(viii) There are some political considerations that influence the government to own commercial units. For example, the government of Tanzania was committed to a form of socialism that it believed was in the best interests of its people.

(ix) In developing countries, there is always a risk that the majority of their industries may be owned or controlled by non-citizens. The government, therefore, finds it appropriate to step in and buy off either the whole or a good part of the share capital of such companies that are owned by non-citizens.

Advantages of Public Ownership

Public ownership has the following advantages:

(i) It reduces income inequalities among the people, because every individual in the society has access to the major means of production; the government is able to reduce the imbalances by providing all the people equal access to social services.

(ii) Exploitation is minimized because the government owns the major means of production, and it provides the majority equal access to the major means of production.

(iii) The government is able to provide a wider network of social services and other investments in the country, because the government can easily plan the allocation of these services and investments even in situations where people may not afford to pay for the services.

(iv) Wastage of resources is minimized; under the public ownership, the government is able to minimize wastage, during the allocation of resources, by controlling wasteful competition among firms.
(v) Economic crises are avoided through proper allocation of resources. The government is able to control economic crises such as unemployment, inflation, overproduction, deflation etc.

Disadvantages of Public Ownership

Public ownership has the following disadvantages:

(i) Inefficient in production and provision of services due to lack of competition.
(ii) Misallocation of resources due to establishment of some investments for political and social factors and not for economic reasons.
(iii) Lack of commitment of the producers because the producers do not own the industries
(iv) There is no strict control of property
(v) Due to public ownership, the private sector is completely ignored.
(vi) There is lack of freedom of consumption and production.
(vii) Since there is no profit motive and the employees are not directly answerable to the government, the efficiency is usually very low.
(viii) Managerial staff of public organisations is appointed because of their political affiliation; they may lack the managerial skills to run the organisations.
(ix) The government enterprises are often too big; hence face the problem of diseconomies of large scale production.
(x) Public ownership leads to emergence of large inefficient monopoly public enterprises.
(xi) There are no strict financial controls in public enterprises, which create loopholes for corruption and embezzlements.
(xii) Losses made by the public enterprises are usually shouldered by the public through raising taxes.

(b) Private Ownership

It is the type of ownership whereby the major means of production are owned by individuals.

Advantages of Private Ownership

Private ownership has the following advantages.

(i) There is freedom of production and consumption; individuals are free to decide on what kind of goods to produce and consume.
(ii) It reduces the government's burden to provide social services to the people
(iii) There is efficiency in production of goods and provision of services due to competition.
(iv) Fast growth of the national income due to efficient production by the private firms
(v) High private initiatives. Individuals are the immediate owners of the firms and profit; therefore, they are encouraged to work hard.
(vi) Proper allocation of resources. Producers produce according to the demand of the consumers. For that case, they do not waste resources on goods which are not demanded by the consumers.

Disadvantages of Private Ownership

Private ownership has the following disadvantages:

(i) Emergence of classes of those who own the major means of production and those who do not own the major means of production.
(ii) The economy may suffer the crises of unplanned economy such as employment and economic recession
(iii) The private sector cannot efficiently provide public goods such as road, railways, defence, education and health.
(iv) Due to lack of control, the private sector, for the sake of maximizing profit, may produce goods which are harmful to the citizens, for example drugs like marijuana and cocaine.
(v) Exploitation may be dominant; those who own the major means of production tend to exploit those who do not own the major means of production.
(vi) The needs of the poor are sometimes ignored, since the producers, under the private ownership, produce luxury expensive goods which are profitable and are needed by the rich people, but ignore the essential goods or welfare goods because they are less profitable

The Private Sector in Tanzania

In Tanzania, the private sector is significant because it performs a number of functions which include:

(i) The private sector employs the majority of the people in Tanzania, thereby raising income and standards of living.
(ii) The sector contributes to the country's Gross National Product (GNP).
(iii) It promotes the growth of the economy since it stimulates entrepreneurship.
(iv) The private sector contributes to the growth and modernization of industries in the country through the vigorous mobilization of private savings, stimulating consumption among individuals and increased investments.
(v) It assists in the exploitation of the available domestic resources; hence reduce excess capacity and wastage of resource utilization.
(vi) The sector uses local raw materials for the local requirements. This leads to a substantial reduction in the country's foreign expenditures.
(vii) In Tanzania, several private sectors activities have been and are continuously being established. This increases the degree of competition and, hence efficiency.
(viii) The government revenue, from taxes, is likely to increase with the expansion of the private sector that can pay the required taxes to the state.
(ix) The role of the private sector is commended as it tends to supplement the little the government funds towards development.
(x) The sector often re-invests (ploughs back) profits. This helps to expand its existing productive capacity.
(xi) Technological development is enhanced as the sector tends to be innovative by adopting new and efficient techniques of production to suit the ever changing consumer tastes and requirements.
(xii) The private sector can help to reduce the subsistence sector through the monetisation of the majority of the economy.
(xiii) The expansion of the private sector is also instrumental in the development of the country's infrastructure.

(xiv) Rural to urban migration can be reduced with the development of the private sectors' activities. This is possible if such activities are located in the rural areas.
(xv) The private sector in Tanzania is highly flexible; it does not only lead to the promotion of exports but also lead to the country's import substitution targets.
(xvi) It should further be noted that the sector is often characterised by a considerable degree of dedication.

Weaknesses/shortcomings/problems of the private sector in Tanzania

The private sector in Tanzania has the following shortcomings:

(i) The country's private sectors have a tendency of fearing the risks involved in business undertakings.
(ii) The sector leads to under-utilization of the domestic resources. This is because not all resources in the country are employed.
(iii) The private sectors' activities that is located in the urban areas often lead to rural to urban migration.
(iv) The sector is also faced with the problem of inadequate financial resources for expanding its activities countrywide.
(v) There is the tendency of using capital intensive techniques of production so as to increase output within the sector. This leads to limited employment prospects for the available potential labour force, that is, unemployment may result.
(vi) The sector tends to be monopolistic in nature by specialising in one or few production activities.
(vii) It may not promote the country's interests since individual desires/aspirations tend to dominate the national interests.
(viii) The private sector, in Tanzania, often concentrates on small scale production activities. This may not enable it to generate adequate economies of scale.
(ix) The high degree of ignorance among the people also greatly hinders the desired activities/targets of the private sector in the country.
(x) The sector is further faced with unpredictable political policies by the government, such that there is the fear of nationalization programmes by the state.
(xi) The prevalent use of rudimentary/outdated technology also limits the scale of production by the Tanzania's private sector.
(xii) The private sector of Tanzania is usually profit motivated. This may act against the expectations of the individual consumers.
(xiii) Capital outflow/profit repatriation can occur where and when the private sectors' activities are under foreign ownership.
(xiv) There is a limited level of diversification due to the production of similar commodities.
(xv) The sector may be faced with the production of poor quality products.
(xvi) It may lead to income inequalities where few people get engaged in such activities, whereas the majority are not.

Policies adopted by the government of Tanzania to encourage and promote the Private Sector

In Tanzania, and indeed in most developing nations, the governments think that private sectors' activities may distort the national development targets, and the private sector views the government as an obstacle to market forces and stimulation of

entrepreneurship. Nevertheless, to make the private sector more effective in Tanzania, some policies have been adopted.

(i) The government has endeavoured to provide both economic and social infrastructure such as power, water, roads, telecommunication networks, etc.
(ii) Trade liberalization has been implemented such that entry into a particular field of economic activity is not restricted.
(iii) The current privatisation programme, in Tanzania, is also aimed at enhancing the government policy of encouraging the private sectors; by transferring state-owned enterprises to the private sector investments.
(iv) The government has maintained security and political stability. This move, too, has helped promoting the private sector.
(v) Economic incentives, such as subsidization policies, tax holidays, etc. have been encouraged by the government to stimulate private sector investments.
(vi) Price stabilization. The stabilization of the market prices of the goods and services, by the government, has cultivated confidence in the private sector investments.
(vii) The private sectors, especially the farmers, have been provided with inputs so as to encourage their production activities.
(viii) The provision of good administrative and social atmosphere which cannot be provided by the private sector.
(ix) Poverty alleviation programmes in which the government has devised regulatory measures and structures to motivate and encourage private investors to channel their savings and investments to benefit the majority.
(x) The government has enabled the extension of a considerable degree of autonomy of the private entrepreneurs on their investment and management decisions.
(xi) Respect of contractual obligations and the protection of property rights, including the intellectual property rights.
(xii) Consistent and uniform application of the government policies aimed at ensuring fair and equal treatment among the private firms, the foreign and the state-owned enterprises.

(c) Co-operative Ownership

It is the type of ownership whereby people with common interest join together to achieve certain economic and social objectives.

In Tanzania, co-operative societies begun during the colonial period with the prime objective of assisting farmers in the production and marketing of their crops. Co-operative societies existed after independence, until 1976, when they were abolished due to their failure to meet their primary objectives.

Advantages of Co-operative Ownership

Co-operative ownership has the following advantages:

(i) *Economies of Scale:* These are economies of scale that members get by joining a co-operative society. Such economies are; marketing economies; storage economies; transportation economies; and accounting economies.
(ii) *Increase in the bargaining power:* When peasants use a co-operative society, their bargaining power increases than when they sell crops to individual buyers.
(iii) *A Co-operative Society may act as an instrument for mass mobilization:* A co-operative society may act as an instrument for mobilizing members of the society for community works such as construction of street or village roads, classrooms, dispensaries, etc.

(iv) *Inputs to members:* Members of a co-operative society can benefit from services that are provided by the co-operative society such as fertilizers, insecticides and technical advice.

(v) *Services to members:* Some co-operatives provide social services such as education and health in their areas.

(vi) *Easy to obtain the governments' assistance:* A co-operative society can easily get financial assistance from the government than individual peasants, because the assets that it owns can act as securities.

Disadvantages of Co-operative Societies

Co-operative societies have the following disadvantages:

(i) *Mismanagement of funds:* Co-operatives are often faced with problems of corruption, embezzlement of funds, theft, non performing loans and big debts borrowed from financial institutions.

(ii) *Low prices offered to the farmers:* Unlike private crop buyers, co-operatives offer low prices for the crops due to lack of enough capital.

(iii) *Large operating costs:* Co-operative societies are faced with the problem of increasing operating costs, such as wages, rent, and transportation, as they expand in size.

(iv) *Lack of democracy:* Often, major decisions are made by key leaders while members are completely ignored.

(v) *Large debts:* These debts arise due to buying of crops on credit and excessive borrowing from financial institutions.

(vi) *Political intervention:* Sometimes, co-operatives societies are used by politicians as organs for mobilizing people to achieve political interests of politicians such as winning elections.

(vii) *Bureaucratic nature:* The co-operatives are bureaucratic in its operations and in making business decisions on what to purchase, when to purchase and where to sale. Several meetings, which often lead to delay in decision making, are carried to decide on the above questions, contrary to private crop buyers who are fast in making decisions, depending on the existing demand conditions.

The dual economies and the informal sector

Dual Economy

A dual economy is the one in which there is a traditional and or pre-capitalistic sector, on one hand, and a capitalistic sector or modern sector on the other hand. The former consists of peasant farmers who use simple methods of cultivation, while the latter consists of miners, large scale manufacturing companies, plantations and large export-import trading companies, as well as all the public services which are operated or controlled by the central the government.

The gap between the traditional and the modern sector exists on sociological and economical levels as follows:

- On the social side; it has been argued that the two sectors have quite separate social systems. In the rural, the traditional sector with indigenous culture, beliefs and religions will dominate, while in the urban, the modern sector and western values will dominate.
- On the economic side; the traditional sector applies small scale and labour intensive technique with little capital, while the modern sector uses capital intensive technique and operates on large scale.

- The modern sector is involved in commercial production, while the traditional sector is primarily involved in subsistence production.
- The traditional sector is dominated by the indigenous people, while the modern sector is often dominated by foreigners, through the multinational companies.
- The modern sector is export oriented, while the traditional sector is for domestic consumption.
- The economic links between the two sectors are often minimal. Modern sector does not buy things from the traditional sector, or sell things to the traditional sector. Hence, it can expand without affecting the traditional sector.

Effects of Economic Dualism

Economic dualism has the following effects:

- It causes social stratification.
- It widens the income gap.
- It can cause rural to urban migration.
- It worsens the living conditions in the rural areas.
- It attracts economic domination by foreigners.
- It retards technological developments in the rural areas.

Informal Sector

This is the sector which comprises unofficial or unregistered activities; it is an intermediate sector existing between the traditional sector and the modern sector. It mainly comprises people who are self employed. Examples of activities in this sector include-hawkers, carpenters, shoe shiners, taxi drivers, photographing and newspaper vendors.

Main features of informal sector

Informal sector has the following features:

(i) The informal sectors' activities are often dominated by low income groups.
(ii) Entry and exit into and from such business operations is free.
(iii) Business in the informal sector is often operated in the open and semi-permanent structures.
(iv) Apart from their limited capital resource base, labour is employed extensively.
(v) The informal sectors' activities are, mostly, located in urban areas and in sub-urban.
(vi) Techniques of production are often poor
(vii) Its activities are usually organised on family basis.
(viii) The government has little control over the sector.

The Roles of the Informal Sector in Tanzania

The informal sector in Tanzania plays the following roles:

(i) The informal sector, being labour intensive, creates employment opportunities, thereby reducing poverty among individual Tanzanian's.
(ii) The sector tends to engage in the production of essential goods and services. This benefits the consumers, especially the low income groups.
(iii) Tanzania can conserve some of her foreign exchange, because the informal sector requires little of it, if any.
(iv) The informal sector in Tanzania, quite often, provides its own training without any cost to the state. This training promotes prospects for entrepreneurship.

(v) Local production activities, such as repair works, marketing, provision of tools and implements, are encouraged and also the provision of cheap and affordable consumer goods that are required for the local communities' daily needs.
(vi) Training cost is low, since the informal sector often produces mainly intermediate goods, such as building materials bricks, tiles, ventilators, furniture, doors, windows, etc.
(vii) The informal sector engages in projects that require small capital, usually raised through family savings. This enables the low income earners and even the unskilled to participate in the production activities.
(viii) The government revenue, through taxation, is likely to increase, since it can be collected from the informal sectors' activities.
(ix) It is a vital source of income for the unemployed such as hawkers, shoe shiners, repairers, etc.
(x) The growth of the informal sector can, consequently, lead to its transformation into a modern and dynamic sector.
(xi) The informal sector promotes the use appropriate technology, given the prevailing suitable conditions in Tanzania.
(xii) The sector has linkages in production, i.e. forward and backward linkages, with other sectors of the national economy. Such linkages tend to lead to the achievement of an integrated economy.
(xiii) The poor of Tanzania need to be supported. Since the informal sector in the country is dominated by the poor, its promotion can go a long with supporting them.
(xiv) The informal sector promotes the spirit of self-sufficiency, thereby reducing the prevailing dependence on simple consumable products and intermediate goods.
(xv) Managerial difficulties are often minimized by the informal sector, since it is locally owned and controlled, in most cases, on family lines.

Tanzania's major economic problems

Tanzania is rated as one of the poor countries in the world. Since independence, it has been facing a number of problems, such as;

- Declining output in all the sectors of the economy.
- Persistent budget deficit.
- Deficit in the balance of payments.
- Increase in the rate of inflation.
- Increase of the national debts.
- Lack of proper in infrastructure.
- Increase in unemployment.
- Misallocation of resources.
- Depreciation of the currency.

Causes of the Problems

- Increase in the price of imports, such as oil.
- The war against Uganda in 1978/1979.
- Collapse of the East African Community, in 1977.
- Bad weather conditions.
- Declining prices of her exports.

- Lack of capital to support her economic sectors such as the agricultural and the industrial sector.
- Corruption and misuse of funds.
- Technological backwardness.
- Lack of entrepreneurial abilities among the Tanzanians.

Solutions to the Problems
In order to solve these problems, Tanzania has been implementing various economic programmes to create economic recovery. These programmes have been influenced by the IMF and the World Bank. Examples of these programmes are as follows:

1. National Economic Survival Programme (1980/1981)
This programme had the following aims:
(i) To correct the deficit in the balance of payments.
(ii) To eliminate food shortage.
(iii) To save the foreign currency earned.

Measures taken
(i) *Trade liberalization*: in which by all the trade restrictions were supposed to be removed.
(ii) *Promotion of export:* In order to promote exportation, the exporters were allowed to retain 50% of the foreign exchange earnings.
(iii) *Removal of bans on trade concerning food items:* Traders were allowed to buy and sell food within and outside the country and the all restrictions concerning inland movement of food were removed.

Effects of trade liberalization
- Trade liberalization increased the supply of goods in the country
- Food supply was improved; areas with surplus food were able to easily supply food to areas with acute shortage of food.

2. Structural Adjustment Programme (1982-1984/1985) - SAP
This programme was intended to bring about the necessary and desirable changes on the structure of:
- Investments
- Consumption
- Exports and imports

Measures taken
- Currency devaluation
- Trade liberalization
- Reduction of expenditures
- Price decontrol

The World Bank and the International Monetary Fund (IMF) have been financing these programmes and other programmes on the following conditions:
(i) *Domestic currency devaluation:* Tanzania has been advised to reduce the value of her domestic currency, in relation to the foreign currencies, in order to stimulate exports, in anticipation that exports will increase. Devaluation makes exports to be cheap and imports to be expensive hence; it enables the country to earn more foreign income.

(ii) *Reduction of the government's expenditures:* In order to reduce the national debts, Tanzania has been instructed, by IMF and the donor countries, to reduce her expenditures in various areas such as education, health, etc. by introducing the cost-sharing system in the consumption of the social services.
(iii) *Privatisation of the economy:* The government has been ordered to privatise the public enterprises as a pre-condition for getting loans. Privatisation also aimed at increasing efficiency in production.
(iv) *Trade liberalization:* It is the policy of removing trade restrictions, such as tariffs, to facilitate trade and reduce the scarcity of the essential goods.
(v) *Price decontrol:* This is the policy whereby the government does not fix the prices of goods and services, but leaves the market forces to determine the prices of goods and services.
(vi) *Political changes:* In this condition, the government is required to improve democracy and human rights status of the country.

Privatisation

Privatisation is the transfer of ownership from state owned enterprises to private ownership.

Forms of Ownership

(i) *Liberalization or deregulation:* This refers to a complete removal of barriers of entry of private individuals to certain investment undertakings, so as to increase competition. This is often done in the export sector, foreign exchange markets, etc.
(ii) *Divestiture:* This involves the complete sale of all shares of the government to the private sector.
(iii) *Partial privatisation:* Also known as joint venture ownership. It occurs when both the government and the private sector own shares in any given undertaking, though the private sector may dominate in the ownership of shares.
(iv) *Repossession:* It is the returning of property or enterprises to their former rightful owners, e.g. the NRM government returned to their rightful owners all properties under the departed Asian Custodian Board.
(v) *Cost sharing:* This is where the government removes or withdraws its financial support from an enterprise and leaves it to the direct beneficiaries; e.g. hospitals, schools, etc.
(vi) *Contracting-out:* This occurs when the provision of goods or services is transferred from the government to the private sector, but the state still retains the sole authority over the ownership. Therefore, it may, for example, privatise only management, but not ownership; hence, management contracts, leases, concessions, etc, have to be signed by the government.
(vii) *Leasing:* It involves leasing out of a state owned enterprise to private individuals. In Tanzania, for example, this has been done in toilets, markets, parks, taxi and bus parks, etc.

Arguments in Favour of Privatisation

There is a popular view, by some economists that market forces tend to allocate resources optimally and more efficiently. The privatisation exercise is deep rooted in a number of arguments, which are advanced in its favour.

(i) The government is often faced with the problem of inadequate capital to finance and maintain the state owned enterprises.

(ii) Corruption and embezzlement by the government officials, consequently results in mismanagement. This, therefore, calls for the privatisation drive.
(iii) There is the argument that the state enterprises require a lot of protection, which is not often common with the private sector undertakings.
(iv) The privatisation programme is vital since it increases the contribution of the private sector to the Gross Domestic Product (GDP).
(v) State firms require a lot of subsidies from the government, which is not always the case with the private sector.
(vi) There is an urgent need to reduce the monopolistic tendency, which often creates inefficiencies. Privatisation can help to avoid this.
(vii) Capital inflow: Privatisation of the state owned enterprises can encourage foreign investment. This will in turn lead to foreign capital inflow.
(viii) Privatisation leads to an optimum utilization of the domestic resources, because the government's control is often characterized by excess resource utilization.
(ix) Reduction of the bureaucratic tendencies of the state sector: With privatisation, quick decision making is possible.
(x) Accountability: The management of firms under private ownership are profit motived; hence it promotes efficiency and accountability.
(xi) To raise revenues: The government can raise enough revenues by transferring its enterprises or assets to the hands of the private sector.
(xii) Employment: Privatisation tends to create employment opportunities in the private sector.
(xiii) A wide tax base: the public sector enterprises, being transferred to the hands of private owners may help widening the tax base.
(xiv) Reduction of a public debt: Privatisation helps reducing the country's debts, especially if the government has a reproductive (self-liquidating) debt.

Arguments against Privatisation

Privatisation has the following disadvantages:

(i) *Capital and profit outflow:* When the state enterprises are sold to foreign investors, excessive capital flight (outflow) is possible. Also, most of the profits may be repatriated outside the country.
(ii) *Social costs:* The society is likely to suffer from negative externalities such as pollution, noise, and poor quality of products.
(iii) *Difficulty in planning:* Privatisation may cause difficulties in planning, since the private sector tends to make its own plans and decisions, some of which may contradict the government's plans.
(iv) *Widening of income inequalities:* Privatisation shifts the wealth of the society from the public/ the government management to few individual's hands, who, as a result, become richer than other individuals in the society hence income inequalities.
(v) *Production of essential goods may be ignored:* Private sector prefers producing luxury expensive and profitable goods to producing essentials with low profit goods. For example, social services and, therefore, lead to fall in the living conditions of the poor majority.
(vi) *Unemployment problem may increase:* The private sectors prefer applying the capital intensive technique of production to applying the labour intensive technique, because of its efficiency.

(vii) *Inefficient supply of public services:* The private sector may fail to provide sufficient public services due to reasons such as the heavy investment required like the construction of railways and ports.

(viii) *Emergence of private monopolies:* Privatisation may transfer state monopolies, which are more accountable to the public and the government, to private monopolies, which are less considerate to the public's interests.

Review Questions

1. Describe and discuss the main sectors of the economy.
2. What are the main features of the agricultural sector in Tanzania?
3. Discuss the role of the agricultural sector in the economy of Tanzania.
4. Discuss the role of the industrial sector in the economy of Tanzania.
5. Explain the linkages between the agricultural sector and the industrial sector.
6. What are the advantages of private and public ownership?
7. Discuss the limitation of co-operative ownership.
8. What are the roles of the small industries in the economic development of Tanzania?
9. Explain why the prices of agricultural products tend to fluctuate.

CHAPTER NINE

ECONOMIC GROWTH AND DEVELOPMENT

Economic Development

Economic development is the quantitative and qualitative improvement in the economy. Economic development, therefore, involves increase in the Gross National product (economic growth) and improvement of the welfare of the people.

Indicators of economic development

Economic development has the following indicators:

- Increase in income per capita.
- High standards of living and low cost of living.
- Decline in illiteracy levels.
- Improvements in technology.
- Fair income distribution.
- Low death rate.
- Advanced infrastructure.
- Large percentage of GNP from the manufacturing sector.
- Social and political stability.
- Low or absence of social cost, such as environment pollution.
- Democratic and human rights such as freedom of expression, free and fair election, freedom of association, freedom of worship etc.
- Efficiency of labour.
- Urbanisation.
- High life expectancy.
- High consumption and investment.
- Low or absence of economic instabilities such as inflation, deflation, budget deficit and deficit in the balance of payments.

  Therefore, economic development is a multi-dimensional concept; its indicators are economic, social and political in nature

Economic growth

Economic growth is the quantitative increase in the national output, that is, it is the increase in the volume of goods and services produced in an economy.

Economic growth differs from economic development in the sense that it covers only the physical aspect of the economy, without considering the socio and political aspects of the economy, therefore, its indicators are only economic in nature. Examples of such indicators are: -

- High growth rate of the Gross National Product
- Improvement of the physical infrastructure
- High income per capita
- Increase in the manufacturing sectors (industrial) development
- Expanding investments and consumption
- Urbanization
- Fall in unemployment

- Economic stability
- Increase in the size of markets
- Efficiency of labour.
- Technological growth.
- Favourable terms of trade and balance of payments
- Large tax revenues
- Increasing social costs, such as environment pollution
- In some situation, growth may be seen by the growing income inequalities among the people and regions.

Determinants of Economic Growth

Economic growth is determined by the following factors:

(i) *Availability of natural resources:* If a country is gifted in natural resources, such as minerals and favourable climate, and they are well utilized, it can easily attain a high economic level, but if a country has less natural resources it will be difficult for the country to realize economic growth.

(ii) *Size of the labour force:* A country with enough and efficient labour force is able to increase its national output than a country with shortage of labour force.

(iii) *Stock of capital:* If a country has a large stock of capital goods, such as machinery, factories, buildings, infrastructures etc, it can easily achieve economic growth, unlike a country with limited capital goods.

(iv) *Entrepreneur capacity:* Entrepreneurs are the owners and investors of various economic enterprises. The growth of investment and the ultimate growth of the economy depend much on the number and efficiency of entrepreneurs. A country with a large number of efficient entrepreneurs may realize a rapid economic growth.

(v) *Political and social stability:* The growth of investments and the resulting economic growth depend much on the social and economic stability of the country. A country with political instability and social unrest hardly achieve any meaningful economic growth.

(vi) *Internal and External Market Size:* A large growth of the economy depends much on the market for the goods produced. Producers are encouraged to increase production if there is a readily available market for the goods and services. In a situation when the market size is so small, producers are discouraged from increasing production; as a result, the country cannot achieve high economic growth.

(vii) *Conducive Environment for Growth of Investments:* Adequate and reliable infrastructure with good the government economic policies on issues, such as tax, stabilization and employment, attract both local and foreign investors in the country and, thus provide the necessary condition for economic growth.

Positive impact of economic growth

Economic growth has the following impact:

(i) *Raises the living standards:* Economic growth leads to an increase in income per capita, which increases the ability of the people to purchase goods and services and, thus improve their living standards.

(ii) *Creation of employment opportunities:* Economic growth leads to more employment opportunities to the people.

(iii) *Development of infrastructure:* Economic growth enables a country to promote the development of her social and economic infrastructure such as transport and communication, energy, health, education etc.

(iv) *Industrial development:* Economic growth provides the necessary conditions for the growth of the industrial sector such as market for industrial products. As a result, it increases the purchasing power of the people, establishment of infrastructure such as electrical power, transport and communication.

(v) *Economic stability:* A country that is experiencing a high economic growth has a stable economy with low inflation rate, low unemployment and a high growth rate of the national income.

(vi) *High Income per capita:* Economic growth leads to the growth of the national income and, thus to an increase in the income per capita.

(vii) *Increase in resource utilization:* Economic growth precipitates an increase in the utilization of the available resources such as capital and land.

(viii) *Growth of towns:* Economic growth leads to an increase in the economic activities in certain areas, such as industrial production, which attracts immigrants of people to the areas, hence construction of more residential buildings and infrastructure such as roads, electricity, tap water system, recreation centres etc, which are the pre-requisites for the growth of towns.

Negative Impacts of Economic Growth

Economic growth may sometimes lead to negative effects as follows:

(i) *Environment Degradation:* Economic growth stimulates the levels of industrialisation, which often result to environment pollution, such as air pollution and water pollution, by emitting poisonous gases to the atmosphere. Also, economic growth may result into an increase in the demand for agricultural raw materials. This gives pressure to the farmers to cultivate more land areas and clear more natural forests, hence cause land degradation.

(ii) *Over-exploitation of Resources:* Economic growth results to excessive demand for a lot of resources, such as minerals, soil, water, therefore, leads to the exhaustion of these natural resources.

(iii) *Rural to Urban Migration:* Economic growth may lead to economic imbalances between the rural areas and the urban areas. These imbalances between the rural areas and the urban areas may be in the form of unequal employment opportunities and unequal across to the social and economic services such as health, electricity and education. As a result, people may be attracted to migrate to the urban areas.

(iv) *Income inequalities:* If the income is not fairly distributed and economic resources are owned by few individuals. Economic growth may result to income inequalities.

Underdevelopment

This is a comparative term. It applies to countries which are developing but are lagging behind in their process of development. Underdevelopment does not mean *absence of development*. It applies to countries which are industrially, technologically, and scientifically and economically less developed. Examples of countries with underdevelopment are Tanzania, Kenya, Albania, Brazil and Bangladesh.

Indicators of Underdevelopment

Some of the indicators of underdevelopment are;

(i) *Low Income per Capita*: In the underdeveloped countries, the income per capita is low due to the low volume of production.

(ii) *Low contribution of the manufacturing sector to the Gross National Product:* In the less developed countries, the contribution of the manufacturing sector is too low. The economy is more dominated by the subsistence agricultural sector.

(iii) *Low technological development:* In the underdeveloped countries, the level of technology is very low; most of the production activities are done by using backward technology.

(iv) *Underutilization of resources:* There is underutilization of resources in the less developed countries due to the poor technology and lack of capital to fully utilize the available resources.

(v) *Economic dualism:* In the underdeveloped countries, there is existence of two sectors at the same time; one is the modern sector and the other one is the traditional sector. This causes lack of an integrated sector, thereby minimising the level of development.

(vi) *High death rates and short life expectancy:* In the less developed countries, the rate of deaths, especially infant mortality rate, is so high and the life expectancy is short due to the poor health services and poor nutrition.

(vii) *High illiteracy rate:* Due to lack of adequate education facilities, many people in the less developed countries are illiterate.

(viii) *Poor housing:* Most of the people in underdeveloped countries live in poor houses (slums) due to their inability to buy the essential building materials such as iron sheets and cement.

(ix) *Economic instabilities:* The underdeveloped countries are, frequently, faced with various economic instabilities such as inflation, balance of payments problems, unemployment and very slow economic growth.

(x) *Political instabilities:* Since political power is an alternative for making a living in these countries, people often struggle to take political power, even by use of force, so that they can control the resources of the country. This leads to endless conflicts in the underdeveloped countries.

(xi) *Lack of capital, skilled labour and entrepreneurs:* The Less developed countries are characterized by limited supply of efficient factors of production, such as modern machinery, skilled labour and efficient entrepreneurs.

(xii) *Economic dependence:* Most of the less developed countries are not economically independent. They depend on the developed countries for economic assistance. Therefore, a large part of their budget depends on foreign aid.

(xiii) *Large rural population:* In the underdeveloped countries, the urban areas are very few in number, and provide little opportunities for employment. Therefore, many people live in the rural areas.

Causes of underdevelopment

Underdevelopment is caused by the following factors:

(i) *Limited stock of factors of production:* Underdevelopment is mainly a result of low production in the country. Low production is often the consequence of a country's lack of the factors of production, such as labour, capital, land and entrepreneurs, and poor organisation of these factors in the process of production.

(ii) *Poor technological development:* If a country lacks the necessary technology to utilize the available resources, such as minerals, soils, forests and water, its level of development will be low.

(iii) *Political instabilities:* If a country is faced with political instabilities, due to wars and civil conflicts, investors will be discouraged from investing in such a country. Also, many of the country's resources will be used for non-productive expenditures, such as buying weapons, instead of investing in the productive sectors such as the industries and the economic services.

(iv) *Poor infrastructures:* Underdevelopment is caused by lack of well developed infrastructure, such as roads, electricity, transport and communication, which are very important for attracting of investments.

(v) *Wastage of resources:* Underdevelopment may also be caused by rampant corruption of the government officials, and poor economic planning, in which the government may allocate resources in non-profitable public enterprises.

(vi) *Unfavourable terms of trade:* Underdevelopment in the less developed countries is, to some extent, caused by unfavourable terms of trade such that the goods which are produced by these countries fetch lower prices in comparison to goods which are produced by the developed countries. This results to a fall in the national income of those less developed countries.

(vii) *Population Pressure:* In the less developed countries, the rate of population growth is very high compared to the rate of economic growth. This leads to poor living conditions given the low capacity of the economy and the government to provide enough goods and services to the people.

(viii) *Debts burden:* Most of the less developed countries, due to low income, are forced to borrow money from internal and external creditors. However, most of the money borrowed is not used in productive projects, as a result, the governments of these countries fail to get enough funds to pay back the debts, and therefore the debt burden increases. This leads to underdevelopment.

Economic Dependency

This is a situation in which a country depends on other nations or donor institutions to achieve its economic goals.

Types of Economic Dependencies

Economic development is divided into the following types:

(i) *Trade dependence:* This is a kind of dependency in which a country depend on international trade to obtain goods and services

(ii) *Capital dependence:* A country depends on foreign capital to enable her run her economic activities.

(iii) *Technological dependence:* A country depends on foreign experts to provide technical know-how in the productive sectors of her economy.

(iv) *Financial dependence:* Financial institutions of foreign countries handle financial affairs of a country, such as banking, insurance, etc.

(v) *Direct dependence:* Foreigners directly engage in the production activities of in the dependent country. This takes the form of multinational investments in the major sectors of the economy, such as mining, tourism, agriculture, transport etc.

Effects of Economic Dependency

Economic dependency has the following effects:

- Dependency may increase the debt burden of a country.
- Dependency, on foreign aid may harm the economic, political and social interest of a country.
- Due to the dependency on assistance from other countries, a country may be given goods of poor quality or which have side effects.
- Dependency on foreign technology and capital may discourage local initiatives from inventing and discovering new local technology.
- It leads to a good political and social relations between the donor country and the dependent country

Theories of Economic Development

An Overview

Development theories have to deal with two challenges. On one hand, development theories analyze the social economic phenomena of Underdevelopment and development. On the other hand, they should be based on problem analysis, and offer strategies for development opportunities. The focus of these different approaches is on economic, social, political or cultural factors. In some measures, these approaches overlap. These theories are divided into classical and modernization theories.

1. *Classical Theories*

Classical theories include;

(a) Harrod-Domar model
(b) Dual sector model
(c) Marxist theory
(d) Dependency theory

(a) Harrod – Domar Model

This model is used in development economics to explain an economy's growth rate in terms of the level of savings and productivity of capital. It suggests that there is no natural reason for an economy to have balanced growth. The model was developed independently by sir Harrod in 1939 and Eusen Domar in 1946. It was the precursor to the exogenous growth model. According to the model, there are the following three concepts of growth:

- Warranted growth
- Natural growth
- Actual growth

Assumptions of the Model

Harrod-Domar model makes the following priori assumptions:

(i) Economic growth depends on the amount of labour and capital, expressed as:
$Y = F(L, K)$, output is a function of capital stock
(ii) The marginal product of capital is constant, and the production function exhibits constant returns to scale. This that implies the marginal and average products are equal.
(iii) Capital is a very necessary input in the process of production
(iv) The product of the savings rate and output is equal to savings which is equal investment, S=I

(iv) The change in capital stock equals investment, less the depreciation of capital stock.

In summary, the saving rate times the marginal product of capital, minus the depreciation rate, equals the output growth rate. Increasing the saving rate, increasing the marginal product of capital or decreasing the depreciation rate, increases the growth rate of output. These are the means of achieving growth on Harrod-Domar model.

Conclusion

Although the model was initially created to help analysing the business cycle, it was later adapted to explain economic growth. Its implication was that growth depends on the quantity of labour and capital. More investment leads to capital accumulation which generates economic growth. The model also had implications for the less economically developed countries, where labour is in plentiful supply but physical capital is not, thus slowing the economic growth.

The less developed countries do not have sufficient average income to enable high rate of savings and, therefore a slow accumulation of capital stock for making investments.

The model implies that economic growth depends on policies for increasing investments, by increasing saving and using that investment more efficiently through technological advancements. The model concludes that an economy cannot find full employment and stable growth rates naturally, similar to Keynesian beliefs.

Criticisms against Theory

(i) The main criticisms of the model are the level of assumptions. For example, that there is no reason for growth to be sufficient to maintain full employment. This is based on the belief that the relative price of labour and capital is fixed, and that they are used in equal proportions. The model explains economic boom and bust by the assumption that investors are only influenced by output (known as accelerator Principle), which is widely believed to be false.

(ii) In terms of development, critics claim that the model considers economic growth and development as the same, whereas in reality, growth is only a subset of development.

(iii) The model implies that poor countries should borrow order to finance investment in to trigger economic growth. However, history has shown that this often causes repayment problems later.

(iv) According to the model, saving is the most important endogenous parameter. But the challenge is; can the parameter be easily manipulated by policy makers? It depends on the much control that the policy maker has over the economy. In fact, there are several reasons to believe that the rate of savings may itself be influenced by the overall level of per capita income in the society, not to mention the distribution of that income within the population.

(b) Dual Sector Model

The dual sector model, in development economics, explains the growth of a developing economy in terms of labour transition between two sectors; the traditional agricultural sector and the modern industrial sector.

Surplus labour, from the traditional agricultural sector, is transferred to the modern industrial sector whose growth, with time, absorbs the surplus labour, promotes industrialization and stimulates a sustainable development.

In the model, the traditional agricultural sector is typically characterized by low wages, abundance of labour and low productivity, through labour intensive production process. In contrast, the modern manufacturing sector has higher wage rates than the agricultural sector, higher marginal productivity and demand for more workers, initially. Also, the manufacturing sector is assumed to use the production process that is capital intensive. So investment and capital formation in the manufacturing sector is possible, overtime, since the capitalists profits are reinvested in the capital stock.

Improvement in the marginal productivity of labour in the agricultural sector is assumed to be a low priority, as the hypothetical developing nation's investment goes towards the physical capital stock in the manufacturing sector. Since the agricultural sector has a limited amount of land to cultivate, the marginal product of an additional farmer is assumed to be zero since the law of diminishing marginal returns has run its course due to the fixed input, land. As a result, the agricultural sector has a number of farm workers who do not contribute to the agricultural output, since their marginal productivity is zero.

The group of farmers, that are not producing any output, is termed surplus labour. Since this cohort could be moved to other sectors without any effect on agricultural output, therefore, due to wage differential between the agricultural sector and the manufacturing, workers will tend to move from the agricultural sector to the manufacturing sector, overtime, to reap the reward of higher wages. If a number of workers move from the agricultural sector, equal to the quantity of surplus labour in the agricultural sector regardless of who actually transfers, general welfare and productivity will improve. Total agricultural product will remain unchanged while total industrial product increases, due to the additional labour, but the additional labour may also drive down marginal productivity and wages in the manufacturing sector. Overtime, as this transition continues to take place and investment results in increase in capital stock, the marginal productivity of workers in the manufacturing will be driven up by capital formation and driven down by additional workers entering the manufacturing sector will by equal to workers leaving the agriculture whilst driving productivity and wages in manufacturing. The end result of this transition process is that the agricultural wage equals the manufacturing wage, the agricultural marginal product of labour equals the manufacturing marginal productivity of labour and no further manufacturing sector enlargement takes place as workers no longer have a monetary incentive to move.

Criticism against the Dual Sector Model

This theory is complicated in reality by the fact that surplus labour is both generated by the introduction of new productivity, enhancing technology in the agricultural sector and the intensification of work. Also, the migration of workers from the countryside to the cities is an incentive towards those two phenomena as the relative bargaining power of workers and employers varies and thus raises the cost labour.

The wage differential between industry and agriculture needs to be a sufficient incentive for the movement between the sectors and, whereas the model assumes any differential will result in a transfer of workers from rural agricultural sector to manufacturing sector.

The model assumes rationality, perfect information and unlimited capital formation in industry. These do not exist in practical situations, and so the full extent of the model is rarely realised. However, the model does provide a good general theory on labour transitioning in developing economies.

Practical Application

The model has been applied quite successfully in Singapore

(c) Marxist Theory by *Ernest Mandel*

According to the Marxist school of thought, human societies have passed through five stages of development, namely, primitive communalism, slavery, feudal, capitalism and socialism. Theory is analysed by Ernest Mandel as follows:

(i) ***Primitive Society and the Origins of the State***

In this stage, the state did not always exist. Certain sociologists and other representatives of academic political science err when they speak of the state in primitive societies. They are actually confusing the state with the community. In so doing, they strip the state of its special characteristic, that is, the exercise of certain functions is removed from the community as a whole to become the exclusive prerogative of a tiny fraction of the members of this community. In other words, the emergence of the state is a product of the social division of labour.

As long as this social division of labour is only rudimentary, all members of the society, in turn, exercise practically all its functions. There is no state and any special state functions. In connection to the Bushmen, Father Victor Ellenberger writes that this tribe knew neither private property nor courts, neither central authority nor special bodies of any kind. Another author writes about this same tribe: "The band, and not the tribe, is the real political body among the Bushmen. Each band is autonomous, leading its own life independently of the others. Its affairs are as a rule regulated by the skilled hunters and the older, more experienced men in general."

The same holds true for the people of Egypt and Mesopotamia in remote antiquity: "The time is no riper for the patriarchal family with paternal authority than it is for a really centralized political grouping. Active and passive obligations are collective in the regime of the totemic clan. Power and responsibility in this society still have an indivisible character. We are here in the presence of a communal and egalitarian society, within which participation in the same totem, the very essence of each individual and the basis for the cohesion of all, places all members of the clan on an equal footing."

But to the extent that social division of labour develops and society is divided into classes, the state appears, and its nature is defined: the members of the collectivity as a whole are denied the exercise of a certain number of functions; a small minority, alone, takes over the exercise of these functions. In general, writing is unknown to primitive society. Thus, there are no written codes of law. Moreover, the exercise of justice is not the prerogative of particular individuals; this right belongs to the collectivity. Apart from the quarrels that are resolved by the families or the individuals themselves, only collective assemblies are empowered to render judgments. In primitive Germanic society, the president of the people's tribunal did not pass judgment: his function based in seeing that certain rules and certain forms were observed. The idea that there could be certain men detached from the collectivity to whom would be reserved the right of dispensing justice, would seem to citizens of the society based on the collectivism of the clan or the tribe, just as nonsensical as the reverse appears to most of our contemporaries.

To sum up at a certain point in the development of the society, before it is divided into social classes, certain functions such as the right to bear arms or to administer justice are exercised collectively - by all adult members of the community. It is only as this society develops further, to the point where social classes appear, that these functions are taken

away from the collectivity to be reserved to a minority who exercise these functions in a special way.

What are the Characteristics of This "Special Way"?

Let us examine the Western society, at the period when the feudal system begun to dominate. The independence (not formal, not juridical, but very real and almost total) of the great feudal estates can be shown by the fact that the feudal lord, and only he, exercises throughout his domain all the functions enumerated above, functions that had devolved on the adult collectivity in primitive societies.

This feudal lord is the absolute master of his realm. He is the only one who has the right to bear arms at all times; he is the only policeman, the only constable; he is the sole judge; he is the only one who has the right to coin money; he is the sole minister for finance. He exercises, throughout his domain, all the classic functions performed by a state, as we know it today.

Later, an evolution takes place. As long as the estate remains fairly small, its population is limited, the "state" functions of the lord are rudimentary and not very complicated, and as long as exercising these functions takes only a little of the lord's time, he handles the situation and exercises all these functions in person. But when the domain grows and the population increases, the functions for which the feudal lord is responsible become more and more complex, more and more detailed and burdensome. It, therefore, becomes impossible for one man to exercise all these functions.

What Does the Feudal Lord Then Do?

He partially delegates his powers to others, but not to free men, since the latter belong to a social class in opposition to the seigniorial class. The feudal lord delegates part of his power to people who are completely under his control: serfs who are part of his domestic staff. Their servile origin is reflected in many present-day titles: "constable" comes from comes stabuli, head serf of the stables; "minister" is the serf ministrable, i.e., the serf assigned by the lord to minister to his needs - to act as his attendant, servant, assistant, agent, etc.; "marshal" is the serf who takes care of the carriages, the horses, etc. (from marah scalc, Old High German for keeper of the horses).

The more the extent that these people, these non-free men, these domestics, are completely under his control, does the seigneur partially delegate his powers to them. This example leads us to the following conclusion - which is the foundation of the Marxist theory of the state:

- The state is a special organ that appears at a certain moment in the historical evolution of mankind, and that is condemned to disappear in the course of this same evolution. It is born from the division of the society into classes and will disappear at the same time that this division disappears. It is born as an instrument in the hands of the possessing class for the purpose of maintaining the domination of this class over the society, and it will disappear along with this class domination.

Coming back to feudal society, it should be noted that state functions exercised by the ruling class do not only concern the most immediate areas of power, such as the army, justice, finances, but also under the seigneur's thumb are ideology, law, philosophy, science and art. Those who exercise these functions are poor people, who in order to live, have to sell their talents to a feudal lord who can take care of their needs. Heads of the church have to be included in the class of feudal lords, inasmuch as the church was

the proprietor of vast landed estates. Under such conditions, at least as long as dependence is total, the development of ideology is controlled entirely by the ruling class: it alone orders "ideological production"; it alone is capable of subsidizing the "ideologues".

These are the basic relationships that we have to keep in mind, if we don't want to get lost in a tangle of complications and fine distinctions. Needless to say, in the course of the evolution of the society, the function of the state becomes much more complex, with many more nuances, than it is in a feudal regime such as the one we have just very schematically described.

Nevertheless, we must start from this transparently clear and obvious situation in order to understand the logic of the evolution, the origin of this social division of labour that is brought about, and the process through which these different functions become more and more autonomous and begin to seem more and more independent of the ruling class.

(ii) The Modern Bourgeois State

Bourgeois Origin of the Modern State

Here, too, the situation is fairly clear. Modern parliamentarism finds its origin in the battle cry that the English bourgeoisie. Hurled at the king, "No taxation without representation!" In plain words this means: "Not a cent will you get from us as long as we have no say on how you spend it".

We can immediately see that this is not much more subtle than the relationship between the feudal lord and the serf assigned to the stables. And a Stuart king, Charles I, died on the scaffold for not having respected this principle, which became the golden rule all representatives, direct or indirect, of the state apparatus have had to obey since the appearance of modern bourgeois society.

The bourgeois State, a class State

This new society is no longer dominated by feudal lords but by capitalism, by modern capitalists. As we know, the monetary needs of the modern state, the new central power, more or less absolute monarchy, become greater and greater, from the fifteenth to the sixteenth century onwards. It is the money of the capitalists, of the merchant and commercial bankers, that in large part fills the coffers of the state.

Ever since that time, to the extent that the capitalists pay for the upkeep of the state, they will demand that the latter place itself completely at their service. They will make this quite clearly felt and understood by the very nature of the laws they enact and by the institutions they create.

Several institutions which today appear democratic in nature, for example, the parliamentary institution, clearly reveal the class nature of the bourgeois state. Thus, in most of the countries in which parliamentarism was instituted, only the bourgeoisie had the right to vote. This state of affairs lasted in most Western countries until the end of the last century or even the beginning of the twentieth century. Universal suffrage is, as we can see, of relatively recent invention in the history of capitalism.

How is this explained?

In the seventeenth century, when the English capitalists proclaimed, "No taxation without representation", it was only representation for the bourgeoisie that they had in mind; for the idea that people who owned nothing and paid no taxes could vote, seemed absurd and

ridiculous to them. Isn't parliament created for the very purpose of controlling expenditures made with the taxpayers' money?

This argument, extremely valid from the point of view of the bourgeoisie, was taken up and developed by the Doctrinaire bourgeoisie at the time of the demand for universal suffrage. For this bourgeoisie, the role of parliament consisted of controlling budgets and expenditures. Therefore, only those who pay taxes may validly exercise this control, because those who do not pay taxes would constantly have the tendency to increase expenditures, since they do not foot the bill.

Later on, the bourgeoisie regarded this problem in another way. Along with universal suffrage, was born universal taxation, which weighs more and more heavily on the workers. In this way, the bourgeoisie re-established the inherent "justice" of the system. The parliamentary institution is a typical example of the very direct mechanical bond that exists, even in the bourgeois state, between the domination of the ruling class and the exercise of state power.

There are other examples of the jury in the judicial system. The jury appears to be an institution eminently democratic in character, especially when compared to the administration of justice by irremovable judges, all members of the ruling class over whom the people have no control.

But from what social layer were, and still in very large measure today, are the members of the jury chosen? From the bourgeoisie, there were even special qualifications, comparable to property-holding requirements for voting, for being able to sit on the jury. A juror had to be a homeowner, pay a certain amount of tax, etc. To illustrate this very direct link between the machinery of the state and the ruling class in the bourgeois era, we can also cite the famous Le Chapelier law, passed during the French Revolution, which, under pretext of establishing equality among all the citizens, forbids both employers' organizations and workers' organisations. Thus, under pretext of banning employers' corporations, when industrial society has gone beyond the corporation stage, trade unions are outlawed. In this way, the workers are rendered powerless against the bosses, since only working-class organization can, to a certain extent (a much too limited extent), serve as a counterweight to the wealth of the employers.

(d) Dependency Theory

Underdevelopment is seen as the result of unequal relationships between the rich developed capitalist countries and the poor developing ones. In the past colonialism embodied the inequality between the colonial powers and their colonies. When the colonies became independent, the inequalities did not disappear. Powerful developed countries, such as the US, Europe and Japan, dominate the dependent powerless LDCs via the capitalist system that continues to perpetuate power and resources inequalities.

Dominant developed countries have technological and industrial advantage that ensures the global economic system works in their own self-interest. Organisations such as the World Bank, the IMF and the WTO have agenda that benefits the firms, and consumers of primarily the developed countries freeing up world trade. One of the main aims of the WTO is to benefit the wealthy nations that are most involved in world trade. Creating a level playing field for all countries assumes that all countries have the necessary equipment to be able to play. For the world's poor countries, this is often not the case.

In this model, the lack of development within the less developed countries rests on the developed countries. Advocates of the dependency theory argue that only substantial reform of the world capitalist system and a redistribution of assets will 'free' the less

developed countries from poverty cycles and enable development to occur. Measures that the developed countries could take would include the elimination of world debt and the introduction of global tax such as the Tobin Tax. This is tax on foreign exchange transactions, named after its proponent, the American Economist, James Tobin, would generate large revenues that could be used to pay off debt or fund development projects.

Problems

- Power is not easily redistributed as countries that possess it are unlikely to surrender it
- It may be that it is not the governments of the MDCs that hold the power, but large multinational enterprises that are reluctant to see the worlds resources being reallocated in favour of the LDCs
- The redistribution of assets globally will result in slow rates of growth in the developed countries and this might be politically unpopular.

Theory of uneven and combined development

This is a Marxist concept that describes the overall dynamics of human history. It was originally used by Russian revolutionary Leon Trotsky around the turn of the 20^{th} when he was analyzing the developmental possibilities that existed for the economy and civilization of the Russian empire and the likely future of the Tsarist regime in Russia. It was the basis of his political strategy of permanent revolution which implied a rejection of the idea that a human society inevitably developed through nonlinear sequence of necessary stages. At first, Trotsky intended this concept only to describe a characteristic evolutionary problem in the worldwide expansion of the capitalist mode of production from the 16^{th} century onwards through the growth of world market which connect more and more people and territories together through trade, migration and investment. His focus was also, initially, mainly on the history of the Russian empire where the most advanced technological and scientific developments co-existed with extremely primitive superstitious cultures. However, in the 1920's and 1930's, he increasingly generated the concept of uneven and combined development to the whole of human history and even processes of evolutionary biology, as well as the formation of human personality.

2. Modernization theory

Is the theory of development which states that, development can be achieved through following the process of development that was used by the currently developed countries.

Modernization theory, in contrast to classical liberalism, viewed the state as a central actor in modernizing the backward or the underdeveloped societies.

Talcolt Parsons functional sociology defined the qualities that distinguished modern and traditional societies. Education was key to creating modern individuals. Technology played key role in this development theory, because it was believed that technology developed and was introduced to the less developed countries.

One key factor in modernization theory is the belief that development requires the assistance of developed countries; to aid the developing countries to learn from their development. In addition, it was believed that the lesser developed countries would develop and grow faster than developed countries. Thus, this theory is built upon theory that it is possible for equal development to be reached between the developed and the lesser developed countries.

Review Questions

1. How does economic growth differ from economic development?
2. What are the main features of economic development?
3. Describe at least two theories of development.

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